

**EARNINGS MANAGEMENT IN THE PROCESS OF
PREPARING CORPORATE FINANCIAL REPORTS**

Mikko Kepsu

Sarja/Series A-3:2012



Turun kauppakorkeakoulu
Turku School of Economics

Copyright Mikko Kepsu & Turku School of Economics

ISBN 978-952-249-195-4 (nid.) 978-952-249-196-1 (PDF)

ISSN 0357-4652 (nid.) 1459-4870 (PDF)

Uniprint, Turku 2012

ABSTRACT

Earnings management (EM) literature examines managers' use of judgment in financial reporting and in structuring transactions to alter financial reports for a specific reason. Mainstream EM literature strongly concentrates on statistical research methodologies and it is driven by positive accounting theory. Although EM occurs in the process of preparing corporate financial reports, that process has so far largely remained a "black box" in prior literature. The purpose of this study is to analyze what EM is, how and why it unfolds and how it is intertwined in the process of preparing corporate financial reports. In order to meet the needs of the study, a qualitative case study method will be used. The contribution of this study is threefold. First, it indicates that the concept of EM is not as unambiguous as the prior literature has assumed. I find that EM is socially constructed and more open to interpretation than absolutely dichotomous conception given by previous studies. Second, this study contributes to our knowledge of the role and the importance of actors involved in conducting EM, indicating that EM is much more actor-dependent than the prior literature has assumed. Third, this study broadens our knowledge base with regard to the processes and potential for EM in academic research.

Keywords: earnings management, corporate financial reporting, IFRS (International Financial Reporting Standards), discretionary accounting items, case study

ACKNOWLEDGEMENTS

I would like to express my gratitude to the people who have contributed to the writing of this thesis. I am especially grateful to my supervisors, Professors Hannu Schadewitz and Kari Lukka. Hannu has unconditionally supported me during this long project and provided crucial comments and assistance. Kari's incisive comments significantly contributed to my learning and this thesis.

I am grateful to my preliminary examiners, Professor Marko Järvenpää and Professor Paul Healy, who gave this work their full attention and used their substantial expertise when commenting on my thesis. I really appreciate the priceless work that you did during the preliminary examination.

The Department of Accounting and Finance at the Turku School of Economics provided an excellent foundation from which to conduct this thesis. The high quality research seminars always challenged my ideas and provided new ways to improve the quality of the thesis. I thank all my current and previous colleagues for their comments on my research. I want to express special gratitude to Markus Granlund, Antti Fredriksson and Erkki Vuorenmaa for their valuable comments.

I also want to thank people who have commented on my work at conferences. Especially, I want to thank Jan Mouritsen and other members of the EAA 2009 doctoral colloquium for their comments. I also thank those people who have contributed to my research by discussing it with me on different occasions.

I wish to thank my case company and its personnel who made it possible to conduct this unconventional research. They showed great open-mindedness and courage in discussing this sensitive topic with me, and also devoted their precious time to my research. I am extremely grateful to all the interviewees in the case company, without your contribution this study would not have had the depth it does.

I am thankful to the foundations that have provided me financial support: the Foundation for Economic Education, the Jenny and Antti Wihuri Foundation, Kemira Foundation, the Finnish Foundation for Economic and Technology Sciences, Turun kaappaopetussäätiö, Turun Kauppakorkeakouluseura, Marcus Wallenberg Foundation, TOP-Säätiö, TSE Support Foundation.

Finally, I thank my parents for their ceaseless support. You have always been there for me. Last, but not least, I express my gratitude to my wife Piia for her never ending support, and my son Severi, who never fails to help me put aside academia and forget my work.

Turku, April 11, 2012

Mikko Kepsu

TABLE OF CONTENTS

1	INTRODUCTION	11
1.1	Motivation for the study	11
1.2	Purpose and methodology of the study	17
2	EARNINGS MANAGEMENT: PRIOR LITERATURE AND ITS IMPLICATIONS FOR THIS STUDY	21
2.1	Corporate financial reporting doctrine	21
2.1.1	The criterion of usefulness for accounting information.....	21
2.1.2	The IFRS framework	23
2.2	Conceptual discussion of earnings management.....	24
2.2.1	Information asymmetry and earnings management.....	24
2.2.2	Concepts of earnings management	25
2.2.2.1	<i>Definitions of earnings management</i>	25
2.2.2.2	<i>Opportunistic vs. informative perspective</i>	27
2.2.2.3	<i>Conceptual continuum</i>	29
2.2.3	Earnings management measurement.....	32
2.2.3.1	<i>Accruals models</i>	32
2.2.3.2	<i>Earnings distribution models</i>	37
2.2.4	The methods for earnings management	38
2.3	Incentives behind earnings management.....	43
2.3.1	Capital market motivations	43
2.3.2	Contracting motivations.....	48
2.3.3	Regulatory motivations	48
2.3.4	Other incentive categorizations.....	49
2.4	Case studies on earnings management	49
2.5	Summary and implications for this study.....	51
3	EMPIRICAL ANALYSIS	55
3.1	Introduction to the empirical section.....	55
3.1.1	Structure of the empirical section and presentation of the case company.....	55
3.1.2	Discretionary issues in the case company.....	57
3.1.2.1	<i>Major discretionary accounting items</i>	57
3.1.2.2	<i>Actors</i>	57
3.1.2.3	<i>Disclosure issues</i>	59
3.2	Adopting and using conservative accounting methods.....	62
3.3	Constructing financial reports	67
3.3.1	Actors' views	67

3.3.2	The concept of the CFO's back pocket.....	70
3.3.3	The importance of meeting the public guidance.....	72
3.3.4	The influence of bonus incentives and decreasing profitability	75
3.3.4.1	<i>Annual financial statement</i>	75
3.3.4.2	<i>Bonus discussion</i>	77
3.3.4.3	<i>Decreasing profitability in unit B</i>	79
3.4	R&D expense activation	81
3.4.1	The delayed timing of the activation	81
3.4.2	Ex-post analysis of the activation and the continuation project	84
3.5	Acquisitions	90
3.5.1	Allocation of acquisition costs.....	90
3.5.2	Earnings management behavior in acquisitions.....	93
3.6	Goodwill impairment testing	96
3.6.1	Background.....	96
3.6.2	The levels for the tests in the annual financial statement	97
3.6.3	Avoiding the impairment loss recognition.....	100
3.6.4	The parameters for the tests	101
3.6.5	The tests during the financial crisis	102
4	DISCUSSION OF THE RESULTS	105
4.1	Introduction.....	105
4.2	The methods and the potential for earnings management	105
4.2.1	The extent and the diversity of the methods and the potential for earnings management	105
4.2.2	New situations and the potential for earnings management	112
4.2.3	The use and the change in earnings management potential.....	116
4.2.4	Conservatism and earnings management.....	118
4.3	Dynamics and the processes behind earnings management	120
4.4	The role of actors and their incentives in earnings management	123
4.4.1	The key role of the CFO	123
4.4.2	Comparison of the two CFOs	124
4.4.3	Incentives for earnings management	127
5	CONCLUSIONS AND EVALUATION OF THE STUDY	129
5.1	Conclusions.....	129
5.2	Evaluation of the study and future research opportunities	132
	REFERENCES.....	137
	APPENDIX: INTERVIEW DATA.....	153

LIST OF FIGURES

Figure 1 The basic nature of mainstream earnings management research 13

Figure 2 Giroux’s (2004) definition of earnings management 29

Figure 3 The distinction between fraud and earnings management (Dechow & Skinner 2000) 31

Figure 4 Choices in financial misrepresentation (Adopted from Jorissen & Otley 2010) 39

1 INTRODUCTION

1.1 Motivation for the study

Earnings management (EM) literature examines the use of judgment by managers in financial reporting and in structuring transactions to alter financial reports for a specific reason. Mainstream earnings management literature mostly uses statistical research methodologies and it is driven by positive accounting theory presented by Watts & Zimmerman (1978; 1979). However, this study is a case study that will shed light on how earnings management originates and occurs in practice in the process of preparing corporate financial reports.

Despite the large amount of earnings management literature, we have quite a limited understanding of the nature, extent and diversity of earnings management (see: Jorissen & Otley 2010; Dechow & Skinner 2000; McNichols 2000; Healy & Wahlen 1999; Schipper 1989). Dechow and Skinner (2000) state that academic research has shown limited evidence of earnings management and McNichols (2000) argues that there is a gap between our institutional knowledge and the actual empirical procedures of earnings management. The main reason for this incomplete knowledge is the narrowness and uniformity of the methodology in prior earnings management research, which strongly concentrates on statistical methods. However, it seems that earnings management is much more complicated a phenomenon than the statistical models are able to test and capture. For example, Dechow and Skinner (2000) criticize commonly used statistical research methodologies and argue that because academics wish to make general statements about earnings management they often examine large samples of firms. Consequently, they tend to use statistical definitions of earnings management that are not very powerful in identifying all aspects of earnings management.

Fields, Lys and Vincent (2001), in their review of empirical studies of accounting choice, including earnings management, state that the field has become too conservative with too many researchers content to justify a methodology because others have used it. Therefore they put forward the view that greater effort ought to be used to employ new methodologies and that the more acceptance of new methodologies could advance the field. They believe that it is necessary to step back from the current research agenda, and to develop the "infrastructure" surrounding the field.

Recently, Kaplan (2011) argues that accounting scholars have distanced themselves from the accounting process itself and that we are likely encountering diminishing returns in several of our research areas.

The increment in our knowledge from the 371st paper on accruals versus cash flows, earnings management, or voluntary disclosure is undoubtedly much lower than the contribution from the first five to ten papers that introduced each topic into the academic accounting literature. (Kaplan 2011, p. 369)

Furthermore, Kaplan (2011) criticizes that accounting scholars, like many of their academic colleagues, exhibit strong herding effects; they follow where others have already gone rather than forging a new path by studying a new issue in an innovative way.

More broadly, Hines (1988; 1991) has criticized mainstream financial accounting research for being based on taken for granted commonsense conceptions and assumptions, which mitigate against questioning how social reality arises and is maintained, subsequently obscuring the roles that financial accounting plays in the creation and maintenance of society. She states that mainstream financial accounting research represents a "way of seeing" similar to the commonsense "way of seeing", but she also argues that a way of seeing is also a "way of not seeing". Hines states that it is necessary to breach a way of seeing or worldview, in order to create new ways of seeing. She refers to breaching a worldview as "stopping the world" or dissolving our taken for granted conception of reality (Hines 1988; 1991). Generally, richer research methods in the area of earnings management have been called for (Jorissen & Otley 2010; Beneish 2001; Fields et al. 2001; Dechow & Skinner 2000; McNichols 2000).

The vast literature on earnings management analyzes large numbers of financial statements by using statistical methods in order to make statistical generalizations and predictions about earnings management. The objective of that research often focuses on understanding whether earnings are being managed in a given context, the type of earnings management and the incentives that shape the environment for discretionary behavior. Figure 1 illustrates the basic nature of mainstream earnings management research.

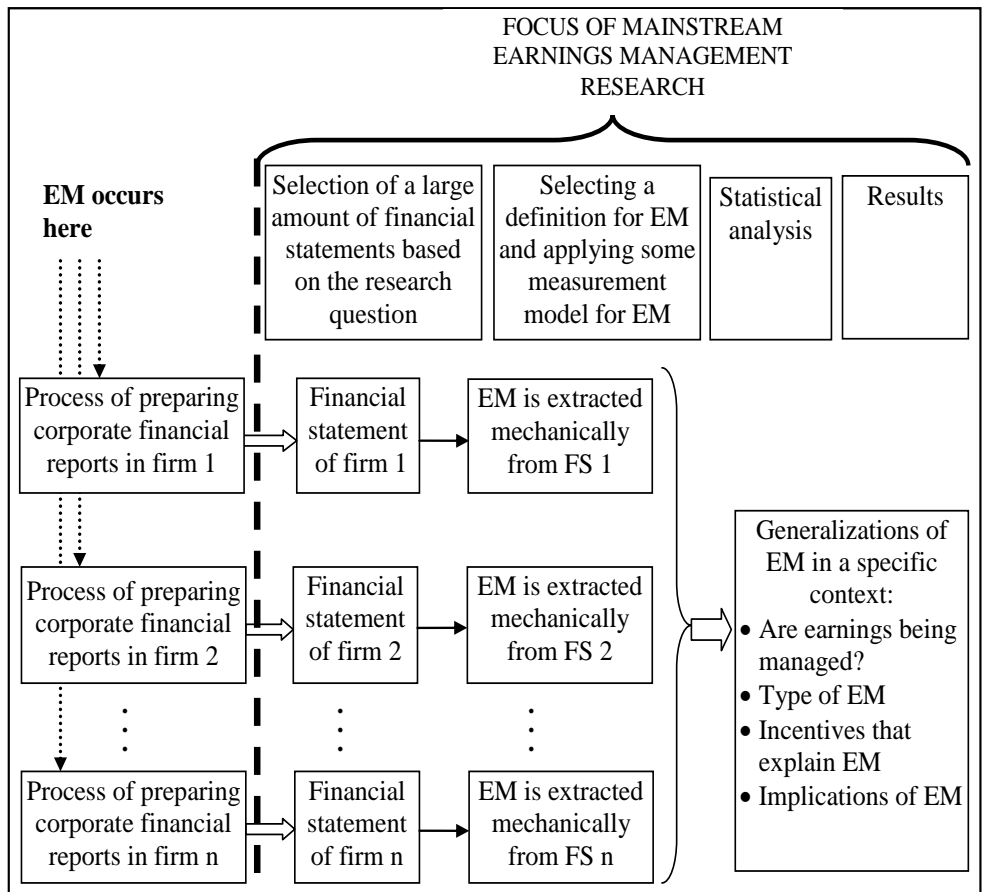


Figure 1 The basic nature of mainstream earnings management research

Figure 1 demonstrates that the mainstream earnings management research starts its analysis from completed financial statements and first selects large numbers of financial statements that have certain common features that are relevant to the research question. Then some testable definition for earnings management is adopted and some earnings management measurement model, such as an aggregate accruals model or specific accruals, is applied in order to mechanically extract earnings management from financial statements. Finally, some statistical analysis is conducted to generate results that are usually generalizations of earnings management in specific contexts (e.g. IPO firms or firms in financial difficulty) that show how earnings have been managed, what type of earnings management has been conducted (e.g. income increasing, income decreasing, income smoothing), or what a manager's incentives to manage earnings were (e.g. bonus plans, political costs and contractual agreements). Although the issues related to earnings management are the focus of a wide area of financial reporting research, many literature reviews note that interpretations of the evidence

of earnings management are, to some degree, controversial (see: Dechow & Skinner 2000; McNichols 2000; Healy & Wahlen 1999; Schipper 1989).

It is commonly known that earnings management is hard to measure and the validity and reliability of earnings management measurement methods have been criticized (Ibrahim 2010; Stubben 2010; Leuz, Nanda & Wysocki 2003; Fields et al. 2001; Xie 2001; Dechow & Skinner 2000; Peasnell, Pope & Young 2000; Thomas & Zhang 2000; Healy & Wahlen 1999; Beneish 1997; 1998; Bernard & Skinner 1996; Guay, Kothari & Watts 1996; Wilson 1996; McNichols & Wilson 1988). Traditionally, earnings management measurement literature has focused on analyzing aggregate accruals (Dechow, Sloan & Sweeney 1995; Jones 1991; DeAngelo 1986; Healy 1985), specific accruals (Nelson 2000; Petroni, Ryan & Wahlen 2000; Beaver & McNichols 1998; Petroni 1992; Moyer 1990; McNichols & Wilson 1988) and the distribution of earnings after management (Jacob & Jorgensen 2007; DeGeorge, Patel & Zeckhauser 1999; Burgstahler & Dichev 1997).

Although there is an enormous amount of literature on earnings management measurement and, although there are number of earnings management models, our knowledge about earnings management is limited and contradictory. The measurement models have been very imprecise in separating earnings management firms from non-EM firms. Another failing is that it is likely that only part of earnings management behavior has been detected. To be more specific, while definitions of earnings management are structured in terms of management intent, in order to statistically test hypotheses researchers must operationalize these definitions and identify what accrual or account is being managed and how, which is difficult to do using only attributes of reported earnings (Dechow & Skinner 2000). McNichols (2000) states that even with a general characterization of how accruals behave in the absence of discretion, there is far more complexity in the behavior of accruals than a simple model allows, thus richer research designs are needed. Following this line of argument, Beneish (2001) has called for case studies on earnings management.¹

A key element of any test of earnings management is a measure of management's discretion over earnings (McNichols 2000). Leuz et al. (2003) state that earnings management is difficult to measure, especially as it manifests itself in different forms. Because extant models provide imprecise estimates of managerial discretion over earnings, questions have been raised as to whether unobservable earnings management actions do in fact occur. Therefore, future work needs to deal with managerial actions that have previously been unobserved and which presumably result in income manipulations (Beneish 2001). Although there are some widely used and quite obvious items like inventories, receivables and pro-

¹ Case studies on earnings management are discussed in 2.4.

visions that can be managed, we are still unaware of the items that actually can be and are managed. In addition, if managers have incentives to manage earnings, they are likely to do so in a way that is difficult to detect, thus reducing the previously applied models' ability to detect earnings management (Beneish 2001). Hence, it would seem fruitful to comprehensively analyze earnings management potential (i.e. items that can be managed) and items that actually are managed.

More generally, the measurement problem primarily arises because to identify whether earnings have been managed, researchers first have to estimate earnings before the effect of earnings management – and this is not an easy task (Healy & Wahlen 1999). Jacob and Jorgensen (2007) state that perhaps the greatest challenge confronting researchers testing for earnings management is specifying what earnings would fall under the null hypothesis, i.e. in the absence of manipulation. Thus the core question is: What kind of managerial discretion should be classified as earnings management, or, more broadly, how should earnings management be measured? Dechow and Skinner (2000) find that certain forms of earnings management are hard to distinguish from appropriate accrual accounting choices, and that it is not obvious when managers' use of accruals becomes earnings management. This highlights the conceptual dilemma of distinguishing between managed and unmanaged financial statements. Mainstream earnings management research has adopted a positivistic viewpoint on that dilemma and uses commonly used measures, even though their validity and reliability has been widely questioned. Thus, there seems to be a need for further discussion of that dilemma and a need for bringing that discussion into the analysis of earnings management.

The mainstream earnings management research simply adopts some definition for earnings management and then unambiguously divides firms between earnings management firms and non-EM firms. In fact, mainstream earnings management research is forced to make simple definition for earnings management – a definition that can be directly measured from the financial statement. Thus, that literature supposes that there is clear distinction or dichotomy between managed and unmanaged earnings, and that there are some neutral earnings that are unambiguous. Furthermore, it is also assumed that the management of a firm unambiguously and unilaterally knows a firm's unmanaged earnings (see: Evans & Schriber 1996). These assumptions are natural, taking into account the positivistic nature of mainstream earnings management literature. However, the reality is not so simple. For example, Giroux (2004) states that the objective of accounting information is to describe financial and economic reality and that the chief financial officer, in conjunction with other executives and board members, develops a perspective on what this economic reality is and how it should be reported. Thus management takes a relativistic position on accounting issues, based

on the perspective it has. Also, Hines (1988, 1991) states that economic reality depends on people's conceptions and therefore there cannot be an unambiguously true or full picture of it. Hines states that people make the picture and construct reality and that the picture is essentially arbitrary and constructed rather than unambiguously true (Hines 1988; 1991).² This suggests that there is a need for an analysis of earnings management that is subjectivistic³ in nature and takes into account the fact that economic reality depends, at least partly, on people's conceptions, while also recognizing that earnings management is a conception that can be disputed. However, the point mentioned above cannot be taken into account by using the statistical earnings management measurement method, on the contrary, it requires a method that analyzes earnings management more comprehensively.

Prior earnings management research has produced evidence of the incentives managers have to manage earnings that relate to political costs minimization, financing cost minimization and manager wealth maximization. However, McNichols (2000) states that there is a need for further research on the factors that motivate managers to manage earnings, and for this understanding to be better reflected in the empirical methods. A better understanding of why managers manipulate earnings will allow researchers to assess the power of alternative earnings management tests, and ultimately strengthen our understanding of the implications of earnings management (Beneish 2001; McNichols 2000). Thus, it would seem fruitful to analyze the incentives more carefully within the context of a firm by exploring, for example, what incentives exist for the different actors.

In the process of preparing corporate financial reports, company management uses its inside knowledge of a firm's current state and business circumstances. The preparation of financial statements in accordance with the International Financial Reporting Standards (IFRS) compels a company's management to make estimations and assumptions that influence the amount of assets, liabilities, income and expenses recorded in its financial statements. In addition, management exercises judgment as it chooses and applies accounting principles, for example, in recording, measuring and presenting information and it is clear that earnings management can occur in those processes (see figure 1). However, to my knowledge, no prior earnings management research has paid serious attention to that process.⁴ Thus, it has so far largely remained a "black box". Mainstream earnings management literature starts its analysis from completed annual state-

² Berger and Luckmann (1966) in their pioneering work define and comprehensively examine the phenomenon of the social construction of reality.

³ See Burrell and Morgan's (1979) subjectivist vs. objectivist continuum for analyzing assumptions about the nature of social sciences.

⁴ The exception is Jorissen and Otley (2010) (presented in 2.4.), however, their study is limited to an *ex post* analysis. In addition, to my knowledge, the prior case studies are limited to the *ex post* analysis of earnings management.

ments or interim reports and, therefore that literature is limited to the *ex post* analysis of earnings management. Given the obvious limitations of that approach, it would seem more fruitful to scrutinize actual earnings management behavior and analyze earnings management as it occurs in the process of preparing corporate financial reports and open the black box.

To sum up, when taking into account the problems and limitations of prior research on earnings management, it would seem fruitful to shed light on the process of preparing corporate financial reports and thus to scrutinize actual earnings management behavior.

1.2 Purpose and methodology of the study

This study aims at increasing the understanding of earnings management in the process of preparing corporate financial reports. The purpose of the study is to ascertain what earnings management is, how and why it occurs and how it is intertwined with the process of preparing corporate financial reports. In order to be able to achieve these purposes, the following questions are addressed:

1. How can we identify earnings management and its potential?
2. How and why does earnings management emerge and what kind of dynamics relate to that?

In order to best achieve the aims of this study, a qualitative case-method approach will be used and a company will be analyzed. Concentrating on one firm facilitates the comprehensive understanding of earnings management issues in that firm. Using Hines' (1988) terms, this study is a momentary breach or stopping of the world of mainstream earnings management literature. Furthermore, by concentrating on the process of preparing corporate financial reports this study expects to open up a "new way of seeing" regarding earnings management.

Prior mainstream earnings management research is creditable in its own context; however, this study aims to complement that literature. The case study method has its own strengths and it has the potential to produce new insights and refine perspectives in ways that statistically based mainstream earnings management research is not able to do.

This study has been conducted by using a qualitative case method that is explorative in nature. Generally, because of their concern with process, qualitative case studies are characterized by having the flexibility to respond to new insights gained from the field by developing, testing, and discarding or refining suitable theories (Ahrens & Chapman 2006).

Lukka (2005) has developed a framework for differentiating between various forms of case research. He suggests a taxonomy that is founded on two analytical

dimensions: the strength and nature of a researcher's empirical intervention and the nature of the theory linkages, i.e. the intended theory contribution of the study. He distinguishes the nature of empirical intervention between non-interventionist and interventionist case research and the theory linkage he distinguishes between theory discovery, theory illustration, theory refinement, and theory testing case research.

With regard to the dimension of the strength and the nature of a researcher's empirical intervention in Lukka's (2005) case research classification, I will apply a case method that is clearly non-interventionist in nature. Furthermore, with regard to the dimension of theory linkage in Lukka's classification, this study can be classified as mainly being of the theory discovery-oriented type, though this research has certain features of theory testing and theory refinement case research. Theory discovery case studies tend to have an emergent, somewhat open-ended character, and, due to their heuristic nature, they have the potential for producing surprising findings (Keating 1995). These studies explicitly aim at developing a new theory or theoretical framework, based on in depth empirical case work and inductive reasoning (Lukka 2005). Keating (1995) states that rather than delivering specified comprehensive theories as such, they tend to produce building blocks for them.

The theory discovery-oriented feature of this study especially relates to opening the above mentioned black box; the issue that is explorative by nature. The theory testing feature relates to, for example, "testing" how earnings management is conducted (e.g. what accruals are managed), or discovering the incentives for earnings management. The theory refinement feature generally relates to elaborating on prior earnings management findings by making them clearer or broadening their scope by, for example, analysing earnings management potential more comprehensively, or analysing how a firm perceives new possibilities for earnings management.

I will justify the methodological choice based on the motivation and on the purpose of the study. The motivation for the study results from the problems that mainstream statistical earnings management research faces and because the process of preparing financial reports is largely considered a black box in earnings management studies. Thus, in the academic research, there is highly limited prior knowledge of the forms of occurrence of earnings management in that process. This implies the use of an explorative case method will be best suited to the purpose of discovering how earnings management occurs. The purpose of the study relates to analysing earnings management behavior during its occurrence. Previous earnings management literature forms a background to my study; however, it will not lead me very far in my analysis of earnings management in the process of preparing corporate financial reports. Thus, the case analysis needs to be explorative in nature.

Broadly, in considering the methodological choices I have balanced the requirements of mainstream earnings management research and qualitative case studies. In other words, on the one hand, I have considered what the methodological requirements and possibilities for a properly conducted case study are. On the other, I have considered what mainstream earnings management literature is ready to accept, as this study aims to contribute to mainstream earnings management literature.

The case firm is a listed Finnish company. The fieldwork for the study took place over two years. The data was collected mainly by interviewing the case firm's key people regarding corporate financial reporting and by an interview with the case's principal auditor⁵ and once observing a board meeting. The preliminary interview was conducted in November 2006 and the last in February 2009. In addition, I conducted a few interviews with two authorized public accountants (APA), who were not contracted to the case company, in order to get expert views from outsiders. The last APA interview took place in November 2009. Twenty-two semi-structured interviews were conducted with 10 people (Appendix). All interviews were conducted in Finnish. All interview guides were sent beforehand to the interviewees and they were slightly modified to suit the individual. The modifications were dependent on the interviewee's position and on the prevailing essential accounting or business-related issues. The average length of the interviews was slightly under two hours. Almost all the interviews⁶ were tape-recorded and transcribed verbatim.

The case method includes triangulation, which, for this study, means gathering data through interviews as well as the careful analysis of the company's internal material and public documents. Generally, the use of multiple data sources is designed to make it possible to provide a more comprehensive and valid portrayal of the phenomenon under scrutiny compared to a single source of data (McKinnon 1988; Yin 1984). In addition, it helps in overcoming the possible distorted effects of the researcher's selective perceptions and interpretations (McKinnon 1988).

As already stated, my case analysis is mainly explorative in nature because the prior earnings management literature did not take me very far in my attempt to open the black box on how earnings management occurs. By concentrating on the actual process of preparing corporate financial reports and analysing earnings management *ex ante*, during its making as well as *ex post* this study is able to bring new insights and perspectives to earnings management analysis and identi-

⁵ The principal auditor, however, refused to specifically comment on the case in particular, and therefore he commented issues only on a general level.

⁶ The preliminary interview with the CFO was not tape-recorded. Neither was the interview with the company's principal auditor, because he prohibited it.

fy discretionary behavior that may not be detected by using only completed financial statements.

This study contributes to our current understanding of earnings management by shedding light on earnings management behavior in the process of preparing corporate financial reports, in other words, in the context where earnings management actually takes place. The general contribution of this study is to open the black box of earnings management. More specifically the contribution is three-fold. *First*, this study indicates that the concept of earnings management is not as unambiguous as the prior literature has assumed. I find that earnings management is socially constructed and more open to interpretation than the absolutely dichotomous conception given by previous studies. *Second*, this study indicates that earnings management is much more actor-dependent than the prior literature has assumed. Therefore it is important to identify the key actor and his characteristics of reasons for conducting earnings management. *Third*, this study reveals some different and previously unexplored processes that occur when making earnings management. It also demonstrates that different situations generate alternate and new possibilities for earnings management. Also, new kinds of discretionary behavior which can also be classified as earnings management have been documented.

This research proceeds as follows: Chapter 2 discusses the relevant earnings management literature, especially the conceptual discussion of earnings management. Chapter 3 is the empirical part of the study that includes stories or narratives from the field. Those stories are descriptive and in that chapter I let the data, or more correctly, the interviewees speak. Chapter 4 discusses the empirical results of the study. Chapter 5 concludes and evaluates the study.

2 EARNINGS MANAGEMENT: PRIOR LITERATURE AND ITS IMPLICATIONS FOR THIS STUDY

In this chapter I present prior literature that is relevant to this study. In 2.1 the corporate financial reporting doctrine is presented in brief. In 2.2 I consider the conceptual issues of earnings management. This conceptual discussion of earnings management is important for this study because the main purpose of this study includes the question: “What is earnings management?” That discussion includes the role of information asymmetry in earnings management, different concepts of earnings management, earnings management measurement and the methods of earnings management. In 2.3 I present the incentives for earnings management that prior literature has analyzed. In 2.4 I present a few case studies on earnings management. In 2.5 the chapter is summarized and the implications are considered.

2.1 Corporate financial reporting doctrine

2.1.1 The criterion of usefulness for accounting information

Broadly, accounting is about the measurement and communication of economic information relevant to decision makers (Watts & Zimmerman 1986). Depending on the users of accounting information, accounting is divided into internal⁷ and external accounting. External accounting, part of which is financial reporting, strives to help stakeholders make decisions concerning their relationship with the firm. As set forth by the IASB’s (International Accounting Standard Board) framework for the preparation and presentation of financial statements, the objective of financial reporting is to provide information regarding an entity’s financial position, performance, and the changes in its financial position to a broad spectrum of users in order to enable them to make rational and informed economic decisions (see: Mackenzie, Coe Tsee, Njikizana, Chamboko & Colyvas 2011; Epstein & Jermakowicz 2007).

⁷ Internal accounting is used for decision-making inside the firm.

Generally, it should produce high quality information that is both useful and reliable and that investors, creditors, authorities and other stakeholders can use in their firm-related decision-making. To achieve the criterion of usefulness aimed for and to support stakeholders' decision-making the financial reporting information needs to be both relevant and reliable. The purpose of the existing accounting regulation, which sets the framework for managers in their financial reporting, is to enhance the relevance and reliability of financial reporting. The core of the regulation constitutes accounting standards that are established and developed by the IASB in the European Union and the FASB (Financial Accounting Standards Board) in the United States.

Ball and Shivakumar (2005) interpret financial reporting quality as the usefulness of financial statements to investors, creditors, managers and all other parties contracting with the firm. The usefulness of financial reporting information is closely related to earnings quality. Schipper and Vincent (2003) define earnings quality as the extent to which reported earnings faithfully represent Hicksian⁸ income and they state that higher quality earnings are closer to Hicksian income than lower quality earnings. Contracting decisions based on low quality earnings or defective earnings will induce unintended wealth transfers. From an investment perspective, low quality earnings are undesirable because they provide a defective resource allocation signal and they are inefficient because they reduce economic growth by causing capital to be misallocated. Thus, earnings quality, and, more broadly, financial reporting quality are of interest to those who use financial reports for contracting purposes and for investment decision-making (Schipper & Vincent 2003).

Kothari, Ramanna and Skinner (2010) state that the primary object of the GAAP is to facilitate efficient capital allocation in the economy. They find that the performance evaluation or the valuation objects as well as the stewardship (i.e. efficient contracting) objects of financial reporting emerge as a consequence of economic forces shaping a GAAP designed to facilitate capital allocation. In addition, many researchers have claimed that an important objective of financial reporting information is its predictive ability related to a firms' future performance and, therefore the predictive ability has been used as a purposive criterion for evaluating the usefulness of financial reporting information since the late 1960s (Bernard 1995; Feltham & Ohlson 1995; Ohlson 1995; Beaver, Kennelly & Voss 1968⁹; Green & Segal 1966). Furthermore, one of the FASB's stated ob-

⁸ The Hicksian income corresponds to the amount that can be consumed or paid out as dividends during a period, while leaving the firm equally well off at the beginning and the end of the period (Hicks 1939).

⁹ Beaver et al. (1968) relate the predictive ability to the purpose of accounting data, i.e. the facilitation of decision-making. Accounting information is considered useful if it is relevant to a particular decision or decision model. If decision-makers can use accounting data to predict an event of interest, then that accounting data is considered relevant and useful to the particular decision.

jectives in providing accounting information is to help investors predict future operating performance.¹⁰ Prior research on financial statement analysis shows that financial statement items and ratios provide information about the future performance of the firm (Fairfield & Yohn 2001; Abarbanell & Bushee 1997; Ou 1990; Ou & Penman 1989).

2.1.2 The IFRS framework

The mandatory adoption of IFRS for listed companies in the European Union is a momentous regulatory change in accounting history. This regulatory change creates new demands for all concerned with the preparation and analysis of financial information and is expected to enhance the comparability of financial reporting, to improve corporate transparency and to increase the quality of financial reporting (see: EC Regulation No. 1606/2002). The IFRS are considered to require the disclosure of more information by companies than they have previously had to give. The extra information is expected to reduce information asymmetry between insiders and outsiders, but recent research has analyzed the impact of IFRS on the quality of financial reporting and found the results to be divergent (Callao & Jarne 2010).

In the IASB's framework the qualitative characteristics of financial statements are understandability, relevance, reliability and comparability. Reliability comprises representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint and that in practice there will often be a trade-off between the characteristics (Mackenzie et al. 2011).

The responsibility for preparing and publishing financial reporting information generally lies with a firm's managers. They are supposed to give a true and fair view of the firm's financial state and performance and they are supposed to use their inside knowledge of the firm's current state and business circumstances in order to create that information. Although the IASB's framework does not specifically include a "true and fair" requirement, it states that the application of the specified qualitative characteristics understandability, relevance, reliability and comparability should result in statements that are presented fairly or are true and fair (see: Mackenzie et al. 2011; Epstein & Jermakowicz 2007).

As stated, managers have to use their inside knowledge of the firm's current state and business circumstances while preparing corporate financial reporting. For example, the preparation of financial statements in accordance with the IFRS

¹⁰ The FASB further states that financial accounting data fulfill this role because past and future operating performance are related.

practices compels the company management to make estimates and assumptions that influence the amount of assets, liabilities, income and expenses recorded in the financial statements, as well as the amount of contingent assets and liabilities presented in the notes on the financial statements. Although these estimations are based on the management's best assumptions of the events and measures taken at the reporting date, the materialized result may deviate from the original estimates. In addition, management exercises judgment as it chooses and applies accounting principles, particularly in cases where the IFRS regulations offer different ways of recording, measuring and presenting data (Case company's financial statements).

2.2 Conceptual discussion of earnings management

2.2.1 *Information asymmetry and earnings management*

Numerous studies suggest that firms adjust¹¹ or modify their financial statements over time.¹² In the 1970s and early 1980s, a wide number of studies investigated the determinants of accounting choice. These studies provided evidence consistent with incentives for managers to choose beneficial ways of reporting earnings in regulatory and contractual contexts (see reviews: Watts & Zimmerman 1986; Holthausen & Leftwich 1983). Since the mid-1980s, studies of managerial incentives to alter earnings have focused primarily on accounting accruals, i.e. accruals management (Beneish 2001). However, during recent years real activities management has also gained attention (see, for example: Roychowdhury 2006).

Earnings management arises from two closely related issues: firstly, from information asymmetry¹³ between managers and external information users; secondly, from the principal agent problem¹⁴ between managers and a firm's other stakeholders. Information asymmetry between managers and external information users makes it possible for managers to use their discretion in preparing

¹¹ Terms such as manipulation, modification, adjustments, smoothing are usually used.

¹² There are also examples of the impudent and fraudulent manipulation of financial statements, some of which led to the worldwide accounting scandals revealed in the beginning of 2000. The scandals raised questions about the reliability and quality of financial statements.

¹³ Information asymmetry occurs when one party to a potential transaction has more information than another. The problem was developed in the economics literature by Akerlof 1970, Arrow 1973, Spence 1973, Stiglitz 1975 and is applicable to accounting information (see, for example: Gonedes, Dopuch & Penman 1976; Gonedes 1978).

¹⁴ The corporate form of business organization usually separates ownership from management that causes the principal agent problem. This is due to incongruence between the aims of management and the owners of the firm (Jensen & Meckling 1976).

and reporting accounting information for their own advantage that is not necessarily in line with the interests of other stakeholders.

Scott (2009) argues that earnings management is managers taking advantage of an asymmetry of information between themselves and the firm's shareholders. Prior literature also demonstrates a relationship between information asymmetry and earnings management and analytically shows that the existence of information asymmetry between management and shareholders is a necessary condition for earnings management (Dye 1988; Trueman & Titman 1988). Generally, earnings management behavior increases as the level of information asymmetry increases (Richardson 2000). Schipper (1989) states that there is information asymmetry between managers and other interest groups and that asymmetry cannot be totally eliminated by changing the contractual agreement. For example, Healy and Wahlen (1999) state that because auditing is imperfect, a management's use of judgment creates opportunities for earnings management, in which managers choose reporting methods and estimates that do not adequately reflect a firm's underlying economics.

2.2.2 Concepts of earnings management

2.2.2.1 Definitions of earnings management

Central to this study is the definition of earnings management. With regard to earnings management there is a wide body of literature but no consensus on the definition of earnings management and there are several different definitions (Beneish 2001; Healy & Wahlen 1999). For example, Scott (2009, p. 403) states that earnings management is the choice of accounting policies, or actions affecting earnings, made so as to achieve specific managerial objectives. Probably the most cited definition for earnings management is that made by Healy and Wahlen:

Earnings management occurs when managers use judgment in financial reporting in structuring transactions to alter financial reports, to either mislead some stakeholders about the underlying economic performance of the economy, or to influence contractual outcomes that depend on reported accounting numbers. (Healy & Wahlen 1999, p. 368)

On the other hand, Davidson, Stickney and Weil (1988) define earnings management as the process of taking deliberate steps within the constraints of gener-

ally accepted accounting principles to bring about the desired level of reported earnings. Watts and Zimmerman (1990) find that earnings management occurs when managers exercise their discretion over the accounting numbers with or without restrictions, and that such behavior can be either firm value maximizing or opportunistic. Schipper (1989) defines managing earnings as a purposeful intervention in the external financial reporting process with the intent of obtaining some private gain. A minor extension of this definition would encompass “real” earnings management, which is accomplished by timing investment or financing decisions to alter reported earnings or some subset of it.

By “earnings management” I really mean “disclosure management” in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say merely facilitating the neutral operation of the process). (Schipper 1989, p. 92)

Jorissen and Otley (2010) use the broader term financial misrepresentation and state that academic research has concentrated almost exclusively on the management of earnings numbers, with most studies examining the presence of earnings management through the analysis of accrual decisions. They find that financial misrepresentation is broader than just earnings management and include the management of balance sheet numbers and disclosure management among other issues.¹⁵

Ronen and Yaari (2008) state that earnings management can be loosely defined as a strategy of generating accounting earnings, which, according to Philips, Pincus and Rego (2003), “is accomplished through managerial discretion over accounting choices and operating cash flows”. Ronen and Yaari (2008) continue by arguing that earnings management is an umbrella notion for acts that affect the reported accounting earnings or their interpretation. This begins from production and investment decisions that partly determine the underlying economic earnings and moves through the choice of accounting treatment and the size of accruals when preparing the periodic reports, and ends in actions that affect the interpretation of the reported earnings, for example, presenting non-GAAP i.e. pro-forma earnings.¹⁶

In general, Beneish (2001) states that a lack of consensus on the definition of earnings management implies different interpretations of empirical evidence in earnings management studies.

¹⁵ They refer to extreme cases such as Ahold, Parmalat, Enron and Worldcom where the balance sheet numbers were also managed.

¹⁶ See: Butler, Leone and Willenberg (2004).

2.2.2.2 *Opportunistic vs. informative perspective*

Beneish (2001) states that there are two perspectives¹⁷ on the incentives for earnings management: the opportunistic perspective that holds that managers seek to mislead investors and the information perspective, first enunciated by Holthausen and Leftwich (1983), under which managerial discretion is a means for managers to reveal to investors their private expectations about a firm's future cash flows, usually referred as signaling. Beneish (2001) states that prior EM research has not been able to distinguish whether managers' exercise of discretion is intended to mislead or to inform, and the typical conclusion in contractual studies is that incentives result in de-facto opportunistic earnings management. In fact, he continues that much prior work has predicated its conclusion on an opportunistic perspective for earnings management and has not tested the information perspective (Beneish 2001). A representational comment, which anecdotally illustrates the opportunistic viewpoint of earnings management study, is the comment by Leuz et al. (2003): "Managers can sometimes use discretionary accruals to increase the informativeness of financial reports."

Healy and Wahlen (1999) find that it is obvious that managers can use accounting judgment to make financial reports more informative for users. This can arise if certain accounting choices or estimates are perceived to be credible signals of a firm's financial performance. They state that if auditing is effective, the managers' estimates of net receivables will be viewed as a credible forecast of cash collections. In addition, managers can use reporting judgment to make financial reports more informative by overcoming limitations to current accounting standards. They find that management's use of judgment in financial reporting has both costs and benefits. The costs are the potential misallocation of resources that arise from earnings management. Benefits include potential improvements in management's credible communication of private information to external stakeholders, thus improving resource allocation decisions. However, Healy and Wahlen (1999) specify that: "Decisions to use accounting judgment to make financial reports more informative for users do not fall within our definition of earnings management." On the other hand, they argue that future research is needed to determine the conditions in which discretion in financial reporting is primarily used to improve communication vs. manage earnings.

Ronen and Yaari (2008) take the view that not all earnings management is misleading. For example, investors prefer to separate persistent earnings from one-time shocks and, in doing so, allow firms that manage earnings in order to allow investors to better distinguish between the two components do not distort earnings. On the contrary, it could be argued such earnings management enhanc-

¹⁷ Scott (2009) views earnings management from a contracting and a financial reporting perspective.

es the information value of their reported earnings. They find that when earnings management maximizes the firm value it is considered economically efficient, and when it does not maximize the firm value it is opportunistic. In addition, they find that earnings management is a collection of managerial decisions that result in not reporting the true short-term, value maximizing earnings known to management. Thus earnings management can be beneficial when it signals long-term value, pernicious when it conceals short- or long-term value and neutral when it reveals short-term performance. The managed earnings result from taking production or investment actions before earnings are realized, or making accounting choices that affect the earnings numbers and their interpretation after true earnings are realized. Ronen and Yaari (2008) also state that their definition relies on the premise that there exists an earnings number (the “short term truth”) that is objective, neutral, and value maximizing (for the firm) in the short run. They state that the advantage of that premise is twofold. First, it confers the ability to distinguish income-increasing earnings management from income-decreasing earnings management. Second, it recognizes that the short-term truth may obscure the long-term truth (Ronen & Yaari 2008).

However, Beneish (2001) points out that signaling can also be seen as misleading, for example if manager understates income by over-providing bad debts, obsolescence or loan losses. The usual signaling argument is that manager action is informative as it helps investors distinguish between weak and strong firms. However, it is also possible that the manager’s action is misleading because the manager may be setting aside income for a rainy day (Beneish 2001).

One of the key issues in studies investigating earnings management has been the question of how it affects the information content of earnings. This is due to the fact that earnings management may hamper the quality of earnings information, which in turn reduces the quality of the financial analyses based on earnings figures. Although there is evidence that both discretionary and non-discretionary accrual components can predict future firm performance (Subramanyam 1996), it is obvious that the use of accruals cannot directly be interpreted as earnings management.¹⁸ For example, Shipper and Vincent (2003) state, “Should we conclude that earnings management increases earnings quality if the result is to increase the predictive ability of earnings?” If managers are income smoothers, then earnings are more predictable. However, Leuz et al. (2003) argue that the resulting smoothed earnings are less informative as a result of the noise added by management intervention. To sum up, managerial discretion can enhance the informative value of earnings by allowing the communication of private information, on the other hand, the misalignment of management’s and shareholders’ incentives could induce managers to use the flexibility provided by

¹⁸ Discretionary and non-discretionary accruals are discussed in 2.2.3.1.

GAAP to manage income opportunistically, thereby creating distortions in reported earnings (Healy & Palepu 1993; Holthausen 1990; Watts & Zimmerman 1986). Thus the effect of earnings management on the informativeness of earnings is far from obvious.

2.2.2.3 *Conceptual continuum*

Giroux (2004) argues that there is no agreement on how the term earnings management should be defined and he finds that earnings management includes the following continuum.

Conservative Accounting	Moderate Accounting	Aggressive Accounting	Fraud
----------------------------	------------------------	--------------------------	-------

Figure 2 Giroux's (2004) definition of earnings management

He finds that earnings management includes the whole spectrum from conservative accounting to fraud, which is a huge range for accounting judgment, given the incentives of management. Thus management takes a relative position on accounting issues, based on its perspective. This perspective can be conservative and result in very few or no nonrecurring or unusual items and complete disclosure. The result should be a close approximation of economic reality and suggest high earnings quality. On the other hand, the perspective can be much more aggressive or even fraudulent (Giroux 2004).

Usually conservativeness is considered a virtue, and one major argument for conservatism is that it serves the needs of creditors well. However, critics of conservatism claim that it facilitates earnings management (see, for example: Jackson & Liu 2010; Penman 2001; Levitt 1998; Hendriksen 1982; FASB 1980; Devine 1963; AICPA¹⁹ 1939). For example, Levitt (1998) alleges that firms purposely understate assets on the balance sheet and subsequently reverse those understatements to inflate earnings. In addition, the IASB's framework of qualitative characteristics of financial statements does not include conservatism. However, as already stated, neutrality is mentioned as one component of reliability.

Jackson and Liu (2010) state that although there have been repeated claims that conservative accounting facilitates earnings management (and is sometimes used to justify information neutrality), there is limited empirical evidence on the

¹⁹ American Institute for Certified Public Accountants

matter. Graham, Harvey and Rajgopal (2005) provide evidence, in their widely-cited survey,²⁰ that many managers admit to drawing down reserves to meet earnings target. In addition, Jackson and Liu (2010) explore the interrelation between conservatism and earnings management by examining an individual accrual account on a balance sheet (the allowance for uncollectible accounts) and its counterpart on the income statement (bad debt expense). They provide initial evidence about the claimed strategic process whereby firms build up “reserves” on the balance sheet (i.e. understate net asset values) and subsequently draw down those reserves to manage earnings. Their results suggest that firms manage bad debt expense to avoid negative earnings surprises by strategically releasing the past over-accrual of bad debt expense into current period earnings. They conclude that conservatism may facilitate earnings management and that conservatism engenders problems that may partially counterbalance some of its claimed benefits. Thus the findings of Graham et al. (2005) and Jackson and Liu (2010) provide evidence that conservative methods can also include manipulative behavior.

Dechow and Skinner (2000) have characterized different types of managerial choices and distinguish between choices that are fraudulent and those that comprise aggressive, but acceptable, ways in which managers can exercise their accounting discretion. Their distinction is presented below in Figure 3.

²⁰ Graham et al. (2005) surveyed and interviewed more than 400 executives to determine the factors that drive reported earnings and disclosure decisions. There are also other surveys on earnings management, for example Nelson, Elliott and Tarpley (2002; 2003) and Hodge (2003), however they rely on third-party perceptions, whereas Graham et al. survey and interview decision makers directly.

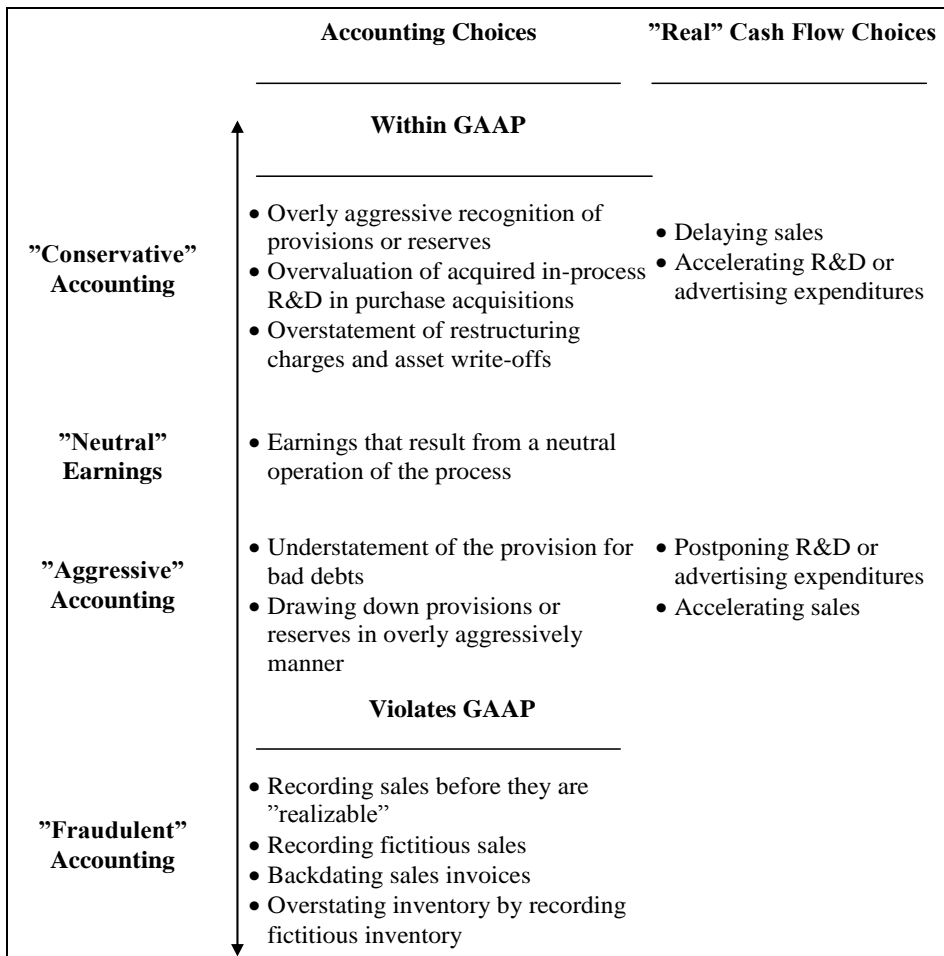


Figure 3 The distinction between fraud and earnings management (Dechow & Skinner 2000)

Thus, according to Dechow and Skinner (2000), there is a clear conceptual distinction between fraudulent accounting practices (that clearly demonstrate intent to deceive) and those judgments and estimates that fall within GAAP and which may comprise earnings management depending on managerial intent. Nevertheless, in the case of the latter types of choice, it would in many cases seem difficult, without some objective evidence of intent, to distinguish earnings management from the legitimate exercise of accounting discretion (Dechow & Skinner 2000). Ronen and Yaari (2008) refers to the figure by Dechow and Skinner (2000), (i.e. Figure 3) and state that "neutral accounting" (i.e. "neutral" earnings) does not include earnings management and that it generates earnings that result from neutral operations. They state that earnings management tactics are spread across decisions that yield conservative earnings i.e. earnings that are de-

flated relative to the truth; decisions that yield aggressive earnings i.e. earnings that are inflated; and fraudulent reports that violate the legislation. As already stated, neutrality is also mentioned in the IASB's framework.

2.2.3 *Earnings management measurement*

2.2.3.1 *Accruals models*

Major managerial discretion relates to using accounting accruals that aggregate into a single measure the net effect of all accounting choices (DeAngelo 1986, 1988; Liberty & Zimmerman 1986; Healy 1985), in other words, numerous recognition and measurement decisions, thereby capturing the portfolio nature of income determination (Watts & Zimmerman 1990). Accruals can be defined as the difference between earnings and cash flow from operations. Conceptually it could further be broken up into non-discretionary and discretionary accruals:

$$\text{Earnings} - \text{Cash flow from operations} = \text{Discretionary accruals} + \text{Non-discretionary accruals}$$

Thus total accruals can be decomposed into non-discretionary (i.e. expected or normal) accruals and discretionary accruals. Non-discretionary accruals are accounting adjustments to a firm's cash flows mandated by accounting standard-setting bodies. Discretionary accruals are adjustments to cash flows selected by the managers. However, the decomposing of accruals between non-discretionary and discretionary accruals is far from obvious and different methods have been proposed (see, for example: Dechow et. al. 1995; Jones 1991). Barth, Cram and Nelson (2001) disaggregate accruals into following major components: change in accounts receivable, change in accounts payable, change in inventory, depreciation, amortization, and other accruals. Accruals will total zero in the long run because the sum of earnings must equal the sum of cash flows over the life of the business. Consequently, any higher-than-normal accruals in one period must be offset by lower-than-normal accruals in another period.²¹

Cheng, Liu and Schaefer (1996) and Dechow (1994) state that the main purpose in using accrual accounting is that accrual accounting matches revenues and expenses better than pure cash flow accounting. Therefore, the use of accrual accounting should improve the assessment of a firm's current performance as

²¹ The question about the quality of accruals was initiated by Sloan (1996) and further modifications have been made by Collins and Hribar (2000), DeFond and Park (2001) and Fairfield, Whisenant and Yohn (2003).

well as improving predictions related to a firm's future performance and future cash flows. Managers have discretion over the recognition of accruals and this discretion can be used by management to signal their private information or to opportunistically manipulate earnings. Signaling is expected to improve the quality of earnings to measure a firm's performance since managers presumably have superior information about their firm's cash generating abilities. However, using accruals may reduce the usefulness of a financial statement if accruals are used for some opportunistic or manipulative purposes (Dechow 1994). As already stated, accruals management involves different accounting choices that try to "obscure" or "mask" true economic performance (Dechow & Skinner 2000).

Generally, previous research has argued that the level of these discretionary accruals reported by a company is a reflection of management's use of the financial reporting discretion inherent in GAAP to either increase or decrease reported earnings (DeFond & Park 2001; Jones 1991; Schipper 1989). Thereby, the most common approach to measure earnings management is based on aggregate accrual models. This wide literature attempts to identify discretionary accruals based on the relationship between total accruals and hypothesized explanatory variables.

The aggregate accrual models use the magnitude of accruals as a proxy for the extent to which insiders exercise discretion in reporting earnings (Leuz et al. 2003). Aggregate accruals literature began with Healy (1985) and DeAngelo (1986) who used total accruals and the change in total accruals, respectively, as measures of management's discretion over earnings. The Jones (1991) model and its modifications (Dechow et al. 1995) are the most widely used in studies of aggregate accruals. Jones introduced a regression approach to control for non-discretionary factors influencing accruals, specifying a linear relation between total accruals and change in sales and property. More generally, in aggregate accruals models total accruals are regressed on variables that are proxies for normal accruals (or expected accruals), and the unexpected accruals (or abnormal accruals) are thus the unexplained (i.e. the residual) components of total accruals.

McNichols (2000) found that from 1993–1999 more studies used an aggregate accruals approach based on the Jones model than any other model.²² She concludes that the large number of studies published that use aggregate accruals suggest that it is widely accepted as a proper proxy for earnings management. Regardless of the popularity of the aggregate accrual approach, it has been questioned in many studies. For example, the validity and reliability of this discretionary proxy have been criticized (Ibrahim 2010; Stubben 2010; Kothari, Leone

²² McNichols reviews the following journals: *The Accounting Review*, *Contemporary Accounting Research*, *Journal of Accounting and Economics*, *Journal of Accounting, Auditing and Finance*, *Journal of Accounting and Public Policy*, *Journal of Accounting Research*, *Journal of Business Finance & Accounting*, *Review of Accounting Studies*.

& Wasley 2005; Xie 2001; Peasnell et al. 2000; Thomas & Zhang 2000; Beneish 1997, 1998a; Bernard & Skinner 1996; Guay et al. 1996; Wilson 1996; McNichols & Wilson 1988). McNichols (2000) states that earnings management measures based on the Jones model and the modified Jones model approach are not sufficiently powerful or reliable to assess earnings management behavior in many contexts likely to be of interest to accounting researchers, standard setters and analysts, and that the models are potentially misspecified and can result in misleading inferences about earnings management behavior. Ibrahim (2010) states that prior literature shows that the current estimates of non-discretionary accruals are plagued with measurement error (see, for example: Thomas & Zhang 2000; Dechow et al. 1995).

The original Jones model has been modified and improvements have been suggested (see, for example: Kothari et al. 2005; Dechow, Richardson & Tuna 2003; Dechow & Dichev 2002; Bartov, Gul & Tsui 2000; Dechow et al. 1995; Kang & Sivaramakrishnan 1995).

Generally, the models of discretionary accruals include expected and unexpected accruals. Therefore, for most earnings management studies, unexpected accruals that arise for reasons other than managerial discretion over financial reporting represent measurement error in discretionary accruals. Among others, Ibrahim (2010) finds that it is very problematic to divide total accruals into the two parts: 1) non-discretionary or the expected level of accruals that is assumed to be the normal level of accruals required for operations, and 2) the discretionary or unexpected accruals which proxies for the firm's manipulation behavior. She finds that the inherent problem is that the researcher can neither observe the true non-discretionary nor the discretionary parts of aggregate accruals. Consequently, a researcher has to make assumptions in order to estimate them. Previous research shows that tests using the known proxies of discretionary accruals in the literature lack power and are misspecified due to the presence of measurement error in these proxies. However, despite the weaknesses, the most commonly used approach to test for earnings management is using the total or aggregate accruals approach (Ibrahim 2010).

The alternative to the aggregate accruals models is to focus on some specific accrual. The seminal paper in this area is McNichols and Wilson (1988) who examine the provision for bad debt. Other specific accrual issues have been for example, loss reserves (Nelson 2000; Beaver & McNichols 1998; Petroni 1992), the allowance of loan losses (Beaver & Engel 1996), different write-offs (Press & Dowdell 2004; Bartov, Lindahl & Ricks 1998; Bunsis 1997; Elliot & Hanna 1996; Francis, Hanna & Vincent 1996; Rees, Gill & Gore 1996; Elliot & Shaw 1988). These studies often focus on industry settings in which a certain accrual is sizeable and requires substantial judgment. Based on these characteristics and anecdotal evidence, the researchers have argued that management's discretion is

likely to be reflected in a specific accrual or a set of accruals. The key aspect of specific accruals studies is modeling the behavior of each specific accrual to identify its discretionary and non-discretionary components (McNichols 2000).

McNichols (2000) lists some advantages and disadvantages to this specific accruals approach relative to the aggregate accruals approach. In brief, the major advantages are: 1) A researcher can develop intuition for the key factors that influence the behavior of the accrual, exploiting his knowledge of generally accepted accounting principles. 2) The approach can be applied in industries whose business practices cause the accrual in question to be a material and likely object of judgment and discretion. A specific industry setting can also provide insight on variables to control and to better identify the discretionary component of a given accrual. 3) It is possible to estimate the relationship between the single accrual and explanatory factors directly.

Among the disadvantages there are three main elements: 1) It is crucial that the specific accrual reliably reflects the exercise of discretion, otherwise the power of the test for earnings management is reduced. 2) It requires more institutional knowledge and data than aggregate accrual approaches. 3) The number of firms may be small relative to the number of firms with aggregate accruals. This may limit the generalizability of the findings of special accruals studies, and it may preclude the identification of earnings management behavior if specific accruals are not sufficiently sensitive (McNichols 2000).

Recently, Ibrahim (2010) found that there still exists model specification for aggregate accrual models, and the way to advance is to examine the specific accruals. One criticism of the papers that have used specific accrual modeling is that they tend to focus on one accrual and ignore the rest, thus potentially leading to a flawed conclusion about the existence of earnings management. She states that prior literature has shown the prevalence of measurement error in models used to estimate aggregate discretionary accruals and that in these models the incremental information content of the various components of accruals is ignored. Therefore she constructs measures that take into consideration the expected managerial manipulation behavior (intentional manipulation) of various components of accruals simultaneously. That goes one step further than the simple disaggregation of accruals into their components and modeling them separately. She shows that it is useful to separate the aggregate accruals into accounts receivable, inventory, accounts payable, other working capital, and depreciation components. She also shows that it appears that managers use either one or more than one component of accruals simultaneously and consistently to manipulate bottom-line earnings in a given direction. She finds evidence that this information is incrementally useful in detecting earnings management and therefore suggests improvements in the discretionary accruals measure by including consistency information from the components of aggregate accruals. Ibrahim states

that when specific accruals are considered separately, the issue arises as to how these accruals are manipulated simultaneously. She proposes that managers undertake the manipulation of the various components of accruals simultaneously in a consistent manner. Thus, income-increasing manipulation is achieved through either positive manipulation in accrual asset accounts and/or negative manipulation in accrual liability accounts (and depreciation). This is consistent with Plummer and Mest (2001) who assert that, in the sample of firms they believe were managing earnings upwards, manipulation was achieved through managing both sales upwards and managing operating expenses downwards (Ibrahim 2010).

Earlier, Beneish (1997) developed a model based on several specific accruals. The model was used to focus on firms from a number of industries and was based on a number of financial statement ratios, several of which relate to specific accruals such as receivables, inventory and accounts payable. In his approach a richer information set is utilized to identify variation in the levels of these specific accruals. McNichols (2000) gives support for Beneish's model and states that if the aim of the research is to identify the magnitude of manipulation on earnings, rather than to test whether it is associated with hypothesized factors, then one would require a model for each specific accrual likely to be manipulated by management.²³

Stubben (2010) concurs with the prior criticism of the different accruals models and finds that an ideal specific accrual for study is one that is common across industries, subject to discretion, and represents a large portion of the earnings discretion available to firms. Therefore, based on these criteria, he suggests revenues as a natural candidate for earnings management measurement. The revenue model by Stubben (2010) is similar to the existing accrual models (Dechow et al. 1995; Jones 1991).²⁴ Stubben's findings indicate that the measures of discretionary revenues do produce estimates with substantially less biased and measurement error than those of accrual models. He states that the results indicate that discretionary revenues detect not only revenues management, but also earnings management via revenues, whereas accrual models do not. He finds that a revenue model is less likely than accrual models to falsely indicate earnings management, and more likely than accrual models to detect earnings management. He concludes that his findings provide support for using measures of discretionary revenues to study earnings management. In addition, his results indicate that

²³ See also Marquardt and Wiedman (2004) who separately model the components of accruals and special items.

²⁴ Stubben lists three differences: 1) he models receivables accrual, 2) he models the receivables accrual as a function of the change in reported revenues, rather than the change in cash revenues, 3) he models the change in annual receivables as a linear function of the two components of the change in annual revenues that are the change in revenues of the first three quarters, and the change in fourth quarter revenues.

the revenue model is less biased and better specified than accrual models, enabling estimates from revenue model to be useful as a measure of revenue management or as a proxy for earnings management. The revenue management has also been studied also by Caylor (2010), Marquardt and Wiedman (2004) and Plummer and Mest (2001).

Stubben (2010) states that despite repeated criticisms of accrual models over the past 15 years, many studies have addressed and continue to address earnings management using these models, presumably because few viable alternatives exist. Stubben points out that during 2005–2008, *The Accounting Review*, *Journal of Accounting and Economics*, and *Journal of Accounting* published at least 40 articles that use a measure of discretionary accruals and the most common approaches to estimating earnings management use aggregate accruals. That indicates that the method is still very popular in measuring earnings management.

To sum up, with regard to the accrual models, the core topic is that researchers need to understand what to expect of normal accruals in order to identify managed accruals and strengthen the power of their empirical tests of earnings management (see, for example: Guay et al. 1996; Jiambalvo 1996). As widely demonstrated that is not an unambiguous issue.

2.2.3.2 Earnings distribution models

One quite popular approach for studying earnings management examines the statistical properties of earnings to identify behavior that influences earnings, as developed by Burgstahler and Dichev (1997) and DeGeorge et al. (1999). They investigate discontinuities in the distribution of reported earnings around three thresholds: 1) zero earnings, 2) last year's (or the last quarter's) earnings, 3) this year's (or this quarter's) analysts' expectations. They make predictions about the behavior of earnings in narrow intervals around these thresholds.

A prime advantage of the distribution approach of earnings is that it allows the researcher to make a strong prediction about the frequency of earnings realizations, which is unlikely to be due to the nondiscretionary component of earnings. However, while examining earnings distributions is informative for indicating which firms are likely to have managed earnings, this approach does not reveal the form and extent of earnings management (Beneish 2001; McNichols 2000).

There is much literature that documents the discontinuity around zero earnings and last year's earnings (Jacob & Jorgensen 2007; DeGeorge et al. 1999; Burgstahler & Dichev 1997; Hayn 1995) and interprets that as evidence of earnings management by firms to just meet or slightly beat the earnings benchmark.

These earnings distribution or discontinuities models are, however, quite widely criticized (Durtschi & Easton 2009; Beaver, McNichols & Nelson 2007;

Durtschi & Easton 2005). There is evidence that the discontinuities are most likely caused by other factors than earnings management. Recently Durtschi and Easton (2009) have criticized them by arguing that despite the evidence that the discontinuities are likely caused by other factors such as scaling and sample selection, these discontinuities are still widely used in the interpretation of evidence of earnings management.

For example, Durtschi and Easton (2009) criticize the study by Jacob and Jorgensen (2007) for claiming to have created a new methodology that may be used universally to check for evidence of earnings management. Durtschi and Easton (2009) state that the methodology of Jacob and Jorgensen (2007) is flawed and that there are more plausible explanations for the earnings distributions than earnings management such as the use of integral method of accounting, sample selection bias, scaling, and averaging. Durtschi and Easton (2009) generally conclude that “Rigorous academic research cannot be based on just an appeal to the popularity of the notion that the shapes of the earnings distributions are evidence of earnings management because: 1) supporting evidence that this is so sparse, perhaps even nonexistent and 2) alternative explanations for the shapes of the distributions are often very evident.”

2.2.4 The methods for earnings management

Generally, earnings management is usually classified into two categories: accruals management and real activities management. Traditionally, earnings management literature is strongly focused on accruals management. However, during recent years real activities management has also gained some ground. More specifically the prior literature has documented that earnings are known to be managed through many different methods (see, for example: Ronen & Yaari 2008; Francis 2001; Ayres 1994; Bruns & Merchant 1990). Jorissen and Otley (2010) summarize that research and present the following choices (figure 4).

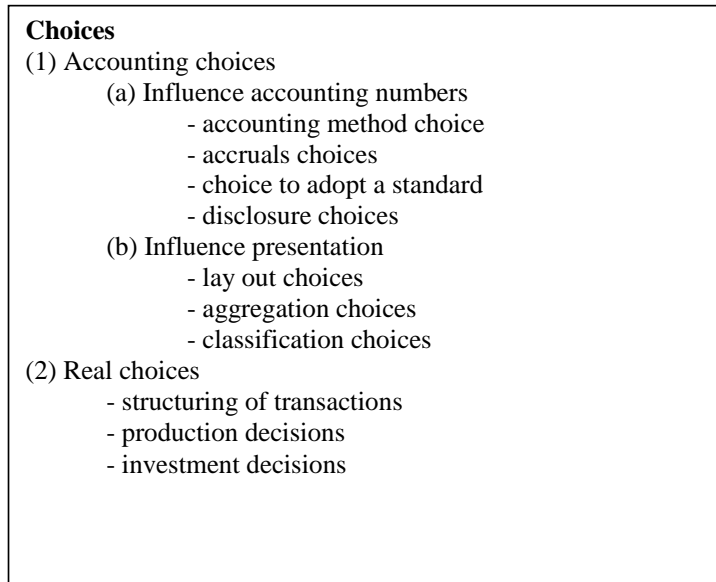


Figure 4 Choices in financial misrepresentation (Adopted from Jorissen & Otley 2010)

The basic classification is between accounting choices and real choices. Accounting choices are divided into: a) influence accounting numbers that includes accounting method choice, accruals choice, the choice to adopt a standard, disclosure choices; and b) influence presentation that includes lay out choices, aggregation choices and classification choices. Real choices include the structuring of transactions, production decisions and investment decisions.

Accounting method choice includes selecting from a menu of treatments that are accepted under the prevailing accounting standards. For example, inventory valuation (Neil, Pourciau & Schaefer 1995; Hughes, Schwartz & Fellingham 1988), depreciation (Neil et al. 1995), revenue recognition policy (Bowen, Davis & Rajgopal 2002). *Accrual choices* are the most studied issues in earnings management and include judgments and estimates required to implement generally accepted accounting rules such as revenue recognition, the estimated service life of long-lived assets, depreciations, asset valuations, the allowance of bad debt, asset write-offs. *Choice to adopt a standard* includes for example, the decision on the timing of the adoption, i.e. the early or delayed adoption of a required accounting rule when there is flexibility, or the decision not to implement a new standard on the ground of immateriality. *Disclosure choices* include, for example, the amount of detail provided in the description of accounting policies.

Lay out choices generally affect the transparency of the presentation or managing the informativeness of earnings. *Aggregation choices* include the extent to

which certain components of, for example, income are displayed as separate line items.

Classification choices include for example, income statement classifications (see: Davis 2002; Givoly, Hayn & D'Souza 1999; Barnea, Ronen & Sadan 1976) in which items are classified above or below the line of operating earnings or earnings from continuing operations in order to separate persistent earnings from transitory earnings, or it may also include for example classifying hybrid securities as equity versus debt. Unlike accrual management and real activities management, income classification shifting does not affect reported bottom-line earnings. McVay (2006) finds that classification shifting (i.e. income statement classification) has been largely ignored.²⁵ Generally, several studies document that analysts and investors pay more attention to “street” or pro-forma or core earnings as defined by managers and view them as being more value relevant than bottom-line earnings (Bhattacharya, Black, Christensen & Mergenthaler 2004; Gu & Chen 2004; Bradshaw & Sloan 2002; Kinney & Trezevant 1997). In addition, core earnings typically receive higher valuation multiples than non-core earnings (Lipe 1986). Thus, it is likely that managers take advantage of the market’s focus on core earnings instead of on bottom-line earnings to misclassify some core expense items in the income statement, i.e. to manage earnings using classification shifting. Managers might also shift expenses across segments to hide abnormal profits (Botosan & Stanford 2005). McVay (2006) finds evidence that managers opportunistically shift expenses from the core expenses (costs of goods sold and selling, general, and administrative expenses) to special items. This vertical movement of expenses does not change bottom-line earnings, but increases core earnings. It seems that managers use this earnings management tool to meet analyst forecasts earnings benchmark, as special items tend to be excluded from pro-forma and analyst earnings definitions. Recently, Fan, Barua, Cready and Thomas (2010) support McVay’s conclusion that managers engage in classification shifting. They use quarterly data and find that classification shifting is more pronounced in the fourth quarter than in interim quarters. To the extent that managers are more constrained in their ability to manage accruals (Brown & Pinello 2007), managers may use classification shifting as an alternative to inflate core earnings (Fan et al. 2010).

Real choices or real activities management, sometimes referred to as real earnings management, occurs when management undertakes actions that change the timing or structuring of an operation, investment, and/or financing transactions in an effort to influence the output of the accounting system. Schipper (1989, 29) includes real earnings management in her definition of earnings management and

²⁵ In fact, McVay (2006) considers classification shifting as a third potential tool for earnings management in addition to the accrual management and real earnings management.

states that real earnings management includes timing investments or financing decisions to alter reported earnings or some subset of it. Roychowdhury (2006) defines real earnings management as management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds.

Gunny (2010) states that traditional earnings management, i.e. accrual management, is not accomplished by changing the underlying operating activities of the firm, but through the choice of accounting methods used to represent those activities. In contrast, real activities management involves changing the firm's underlying operations in an effort to boost current-period earnings. Both types of earnings management involve attempts by managers to increase or decrease earnings. However, the real earnings management affects operations and the accruals management does not affect operating activities (Gunny 2010).

In the above mentioned classification, real choices are divided into three parts: The *structuring of transactions* involves certain ways to achieve a desired accounting outcome, for example many forms of off-balance sheet financing. *Production decision* and *investment decision* both relate to real earnings management issues, such as reducing expenditures on R&D or advertising.

Gunny (2010) lists several reasons why managers may prefer real activities management to accruals management. First, *ex post* aggressive accounting choice with respect to accruals are at higher risk of being subject to legal scrutiny or class action litigation. In fact, through an analytical model Ewert and Wagenhofer (2005) demonstrate that real earnings management increases when the tightening of accounting standards makes accruals management more difficult. Second, a company may have limited flexibility to manage accruals. For example, accruals management is constrained by the business operations and accrual management that took place in prior years (Barton & Simko 2002). In addition, accruals management must take place at the end of the fiscal year or quarter, and managers face uncertainty as to which accounting treatments the auditor will allow at that time. The operating decisions are controlled by management, whereas accounting choices are subject to auditor scrutiny. On the other hand, management may prefer accruals management to real activities management because accruals management can take place after the fiscal year end when the need for earnings management is most certain, whereas real earnings management related decisions must be made prior to the fiscal year end (Gunny 2010).

Generally, real earnings management is traditionally measured so that a model is developed that estimates the expected (i.e. normal) level for the operational activities associated with real earnings management (see: Roychowdhury 2006; Herrmann, Inoue & Thomas 2003; Berger 1993).

Probably the first study relating to real earnings management was conducted by Lambert (1984) who examines real smoothing and models it as the outcome

of the principal-agent relationship between the owners and the manager. Prior literature provides evidence of real earnings management, such as overproduction to decrease the cost of goods sold, cutting desirable R&D investments to boost current period earnings (i.e. underinvest in R&D), sales manipulation (price discounts), the reduction of discretionary expenditures and overproduction (see: Gunny 2010; Oswald & Zarowin 2007; Roychowdhury 2006; Cheng 2004; Herrmann et al. 2003; Bens, Nagar & Wong 2002; Thomas & Zhang 2002; Bushee 1998; Bartov 1993; Baber, Fairfield & Haggard 1991; Cooper & Selto 1991; Dechow & Sloan 1991; Trueman & Titman 1988).

The use of real earnings management is strongly supported by Graham et al. 2005 in their widely-cited survey. They provide surprising evidence suggesting that managers prefer real earnings management activities compared to accrual-based earnings management and that most earnings management is achieved via real actions as opposed to accounting manipulations. This is the case since real earnings management activities are less likely to be scrutinized by auditors and regulators, and therefore potentially have a greater probability of not being detected, although the consequences of such actions can be economically significant to the firm. Managers also candidly admit that they would take real economic actions, such as delaying maintenance or advertising expenditure, and would even give up positive NPV projects to meet short-term earnings benchmarks.

We find strong evidence that managers take real economic actions to maintain accounting appearances. In particular, 80% of survey participants reports that they would decrease discretionary spending on R&D, advertising and maintenance to meet an earnings target. More than half (55.3%) state that they would delay starting a new project to meet an earnings target, even if such delay entailed a small sacrifice in value. (Graham et al. 2005, p. 32)

Graham et al. (2005) found that such unambiguous managerial intent to burn economic value to meet financial reporting goals has not been previously documented. They find it surprising that managers would rather take economic actions that could have negative long-term consequences than make within-GAAP accounting choices to manage earnings. They consider it disturbing that the majority of CFOs admit to sacrificing long-term economic value to hit the target or to smooth short-term earnings. Such actions suggest a flaw in corporate governance practices. They find it surprising that executives are more reluctant to employ within-GAAP accounting discretion, such as accruals management, to meet earnings targets, although accruals management is likely cheaper than giving up economic value. However, this tendency to substitute real economic actions in place of accounting discretion might be a consequence of the stigma attached to

accounting fraud in the post-Enron and post-Sarbanes-Oxley world conclude Graham et al. (2005).²⁶

2.3 Incentives behind earnings management

Prior literature has provided an enormous amount of evidence of different incentives behind earnings management. I present the incentive categorization by Healy and Wahlen (1999) that includes: 1) capital market motivations, 2) contracting motivations and, 3) regulatory motivations.²⁷ Based on prior research, the first two categories are the most important incentives that seem to be driving earnings management. The capital market-related studies focus on widely diverse issues, whereas earnings management studies on contracting incentives are generally focused on debt contracts and management compensation contracts.

2.3.1 *Capital market motivations*

Capital market motivations include incentives that relate to market expectations and valuation issues. Healy and Wahlen (1999) state that the widespread use of accounting information by investors and financial analysts to value stocks can create incentives for managers to manipulate earnings in an attempt to influence short-term stock price performance. Typically firms that report earnings greater than expected enjoy share price increase and conversely, firms that fail to meet expectations suffer a share price decrease (Bartov, Givoly & Hayn 2002; Skinner & Sloan 2002). Therefore, managers have a strong incentive to ensure that earnings expectations are met.

Prior research has documented three important earnings-related thresholds to manager earnings: 1) avoiding losses, i.e. reporting positive earnings, 2) earnings increase, especially in annual earnings and seasonally adjusted quarterly earnings, and 3) meeting or beating analysts' expectations for quarterly earnings, i.e. positive or zero earnings surprises (see: DeGeorge et al. 1999; Burgstahler & Dichev 1997; Hayn 1995). In addition, the market rewards for meeting or beating these thresholds and the market penalty for not meeting these thresholds have both been documented as being large (Das & Zhang 2003; Bartov et al. 2002, Kasznik & McNichols 2002; Lopez & Rees 2002; Skinner & Sloan 2002; Barth, Elliot & Finn 1999).

²⁶ Also Cohen, Dey and Lys (2008) find that managers have shifted away from accrual management to real earnings management in the post Sarbanes-Oxley Act (SOX) period.

²⁷ For example, Fields et al. (2001), present three categories for accounting choice: 1) contractual motivations, 2) asset pricing motivations, 3) motivations due to the impact on third parties.

Scott (2009) finds that the above mentioned incentives are well known among investors and managers and this makes meeting expectations all the more important for managers. If these benchmarks are not met, the market will reason that if the manager could not find enough discretionary flexibility to avoid the shortfall, the firm's outlook must be bleak indeed, and/or the firm is not well managed since it cannot predict its own future. This could explain a more severe market penalty for failure to meet expectations, especially if the shortfall is small (Scott 2009). He continues by noting that managers who miss earnings expectations may offer explanations for that. Barton and Mercer (2005) provide evidence about analysts' reaction to managers' explanation for poor performance. They find that if an explanation is plausible, analysts will increase both their earnings forecasts and their opinion of the management, but if the explanation is not plausible, earnings forecasts decrease and opinions about the management become more critical. Scott (2009) emphasizes that the failure to meet investors' expectations has serious consequences. There is a direct effect on a firm's share price and the cost of capital as investors revise their estimations downwards. There can also be an indirect effect on a manager's reputation. Thus, meeting expectations and maintaining reputations are powerful earnings management incentives (Scott 2009).

Keung, Lin and Shih (2010) find that firms collectively incur a cost for managing earnings and analyst expectations to meet earnings forecasts. They demonstrate that investors are right to be skeptical about minor positive earnings surprises, i.e. investors' skepticism toward zero and small positive earnings surprises is justified. Their results are consistent with the Akerlof's (1970) prediction that if the quality of a good is difficult for potential buyers to assess, they will pay lower prices, even for units of the good that are of high quality. Keung et al. (2010) made the first study to document how firms collectively incur a cost for playing the numbers game as a result of a backlash by analysts and investors.

The capital market motivations also include studies of earnings management in periods surrounding capital market transactions, such as equity offers and management buyouts. As an example, the findings indicate that firms report income increasing unexpected accruals prior to seasoned equity offers (Teoh et al. 1998a), initial public offers (Teoh et al. 1998b) and stock-financed acquisitions (Erickson & Wang 1999). Perry and Williams (1994) provide evidence of earnings management prior to management buyouts and produce evidence of income decreasing unexpected accruals prior to management buyouts.²⁸

This incentive category also includes research investigating whether managers use earnings management in an effort to manipulate the stock price to increase

²⁸ See, also DeAngelo (1986).

their stock based pay²⁹ or to benefit from insider trading³⁰. Extant literature has focused primarily on how CEO equity incentives affect earnings management, and prior research. It suggests that CEO equity incentives are associated with accruals management (Bergstresser & Philippon 2006) and the possibility to beat analysts' forecasts (Cheng & Warfield 2005).

Recently, Armstrong, Jagolinzer and Larcker (2010) have examined whether CEO equity-based holdings and compensation provide incentives to manipulate accounting reports. They refer to 10 recent studies that have examined the same relationship.³¹ These studies generally hypothesize that equity based compensation and holdings provide incentives for managers to manipulate accounting numbers. However, Armstrong et al. (2010) state that no conclusive set of results has emerged from the literature and that the results of prior studies are inconsistent. That highlights the difficulty in drawing general inferences regarding the association between equity incentives and accounting irregularities from the prior literature. Therefore, they state that there is mixed evidence about the matter and consider it an open question. They use a larger sample that is more representative of the economy and an econometric approach that better alleviates the bias and provides an assessment of hidden bias. They find little evidence of a positive relationship between CEO equity incentives and the incidence of accounting irregularities, and, in contrast to most prior studies, after matching CEOs to the observable characteristics of their environments they find no evidence of positive association. On the contrary, they find some evidence that accounting irregularities occur less frequently at firms where CEOs have relatively higher levels of equity incentives. They conclude that, if anything, their results suggest that higher equity-based compensation and holdings may actually reduce the incidence of improper financial reporting (Armstrong et al. 2010).

Jiang, Petroni and Wang (2010) investigate whether chief financial officer (CFO) equity incentives are associated with earnings management and the incremental role of CFO equity incentives in earnings management relative to those of the CEOs. They motivate their study by stating that because a CFO's primary responsibility is financial reporting and CFOs can significantly affect accounting quality a CFO's equity incentives should therefore play a stronger role than those of the CEO in earnings management. Their evidence suggests that the role of the CFO equity incentives is greater than that of the CEO. In addition,

²⁹ Here I classify as capital market incentives the compensation contracts that directly relate to stock price, and I also classify contracting motivations as the compensation contracts that relate to accounting figures.

³⁰ Beneish and Vargus (2002) state that insiders have an information advantage regarding earnings quality. They show that the one-year-ahead persistence of income-increasing accruals are significantly correlated with insider trading and state that insider trading appears to have a connection with earnings management.

³¹ See the studies referred to by Armstrong et al. (2010).

the CFO equity incentives play an independent role in companies' earnings management activities, even after controlling for CEO equity incentives. However, they state that their findings may reflect the impact of other lower-level executives in the organization, and therefore one should be cautious in attributing their findings on the relationship between CFO equity incentives and earnings management solely to the actions of the CFO (Jiang et al. 2010).

Graham's et al. (2005) survey provides much evidence on incentives and especially relates capital market incentives to earnings management. The two most important earnings benchmarks are quarterly earnings for the same quarter last year and the analysts' consensus estimate. Meeting or exceeding benchmarks is very important. In fact, managers describe a trade-off between the short-term need to "deliver earnings" and the long-term objective of making value-maximizing investment decisions. Executives believe that hitting earnings benchmarks builds credibility with the market and helps to maintain or increase their company's stock price. In addition, the severe reactions to small EPS misses can be explained as evidence that the market believes that most firms can "find the money" to hit earnings targets. Not being able to find one or two cents to hit the targets might be interpreted as evidence of hidden problems in the company (Graham et al. 2005).

Graham's et al. results indicate that executives have strong preferences for smooth earnings, and that an overwhelming majority of CFOs prefer smooth earnings to volatile earnings. In addition, regarding holding cash flows constant, volatile earnings are thought to be riskier than smooth earnings. Furthermore, it is easier for analysts to predict smooth earnings, and the respondents believe that smoother earnings improve the predictability of future earnings, which in turn increases stock price. Graham et al. state that the predictability of earnings is an overarching concern among CFOs and that executives believe that less predictable earnings – as reflected in a missed earnings target or volatile earnings – command a risk premium in the market. The consequences of a failure to smooth earnings are perceived to be severe. In fact, a surprising 78% of the surveyed executives would give up economic value for smooth earnings. Most executives feel they are making an appropriate choice when sacrificing economic value to smooth earnings or to hit a target. That is, the possible turmoil that can result from negative earnings surprise can be very costly, at least in the short-run. Therefore, many executives find that they are choosing the lesser evil by sacrificing long-term value to avoid short-term turmoil. Graham et al. think that given the reality of severe market (over)reactions to earnings misses, executives might be making the optimal choice in keeping an existing equilibrium (Graham et al. 2005).

Graham et al. find that managers want to meet or beat earnings benchmarks to:
1) build credibility with the capital market; 2) maintain or increase the stock price;

3) improve the external reputation of the management team; 4) convey future growth prospects. Failure to hit earnings benchmarks creates uncertainty about a company's prospects and raises the possibility of hidden, deeper problems in the company. They suggest that CFOs manage financial reporting practices to influence their stock price in general and current stock price in particular. Their analysis indicates that managers worry about short-run stock prices because they believe that short-run stock price volatility affects a company's cost of capital, CFOs and CEOs are concerned about losing their jobs if the stock price falls, managers think that the labor market assesses their skill level based on short-run stock prices, managers seek to attract equity analysts to cover their stock and they seek to avoid embarrassing questions by stock analysts in conference calls if the stock price falls. Graham et al. state that although their study did not find strong support for the bonus hypothesis, exercisable stock options held by managers suggest another reason why managers care about short-run stock prices. They also provide evidence that voluntary disclosure is an important tool in a CFO's arsenal and that companies make voluntary disclosure for three main reasons: 1) to promote a reputation for transparent reporting; 2) to reduce the information risk assigned to the company's stock; 3) to address to deficiencies of mandatory reporting (Graham et al. 2005).

In general, Graham et al. find that executives often employ simple decision rules or heuristics in response to a handful of widely held beliefs about how outsider and stakeholders will react. These anticipated reactions are the "rules of the game" that dictate the playing field for many earnings management and disclosure decisions. The rules most likely include the following beliefs: 1) the stock market values the predictability of earnings because market participants hate the uncertainty created by a company failing to hit the earnings benchmark or by earnings that are not sufficiently smooth; 2) there is a widely held belief that every company manages earnings to hit targets, so if one company does not manage and misses a target, it will be punished; 3) because every company manages earnings, if a company misses a benchmark it is thought to have revealed previously hidden problems at the company, worsening the perception of future growth prospects; 4) managers try to maximize smoothness in earnings and volatile earnings are bad because they convey higher risk and/or lower growth prospects; 5) firms should voluntarily disclose market-moving information because doing so results in lower information risk. They suggest that future research can explore why and how these rules are selected and the implications of these rules for financial reporting policies in greater depth (Graham et al. 2005).

2.3.2 Contracting motivations

Contracting motivations include incentives that relate to contracts written in terms of accounting numbers. A large literature has emerged to test whether incentives created by compensations and lending contracts can explain earnings management.

Studies examining the bonus hypotheses provide evidence consistent with managers altering reported earnings to increase their compensation (Gaver, Gaver & Austin 1995; Holthausen, Larcker & Sloan 1995; Healy 1985). Healy and Wahlen (1999) divide the compensation contracts into actual contracts and into implicit contracts or relational contracts. Actual compensation contracts are accounting number based bonus awards. The implicit compensation contracts relate, for example, to situations in which top managers' job security is threatened or their expected tenure with the firm is short (Healy & Wahlen 1999). Bowen, DuCharme and Shores (1995) investigated implicit contracting and argued that a manager's implicit contracting reputation can be bolstered by high reported profits, which increase stakeholders' confidence that the manager will continue to meet contractual obligations.

Studies examining lending contracts motivations have examined whether firms that are close to lending covenant violation manage earnings. Healy and Palepu (1990) and DeAngelo, DeAngelo and Skinner (1994) find only a little evidence of earnings management among firms close to their dividend covenant. DeFond and Jiambalvo (1994) and Sweeney (1994) investigated a sample of firms that actually violated a lending covenant, but found mixed evidence. DeFond and Jiambalvo (1994) found income increasing earnings management one year prior to the covenant violation. Sweeney (1994) also finds income increasing earnings management behavior but such that typically occurs after the covenant violation. That indicates that the sample firms did not conduct earnings management in order to avoid violating the lending covenant, although it is possible that the discretion was conducted in order to avoid future covenant violations. There are also other studies that document evidence of debt-covenant hypothesis (see, for example: Beatty & Weber 2003; Dichev & Skinner 2002; Jaggi & Lee 2000).

2.3.3 Regulatory motivations

The third category, the regulatory motivations, includes incentives that relate to anti-trust or other government regulation. Generally, it is often alleged that managers of firms vulnerable to an anti-trust investigation or other adverse political consequences have incentives to manage earnings to appear less profitable (Watts & Zimmerman 1978). Earnings management studies suggest that regula-

tory considerations induce earnings management (See: Key 1997; Cahan 1992; Jones 1991). In particular, banking, insurance and utility industries are more regulated and it is frequently asserted that regulation in these industries creates incentives to manage earnings of interest to regulators. A number of studies provide evidence consistent with this hypothesis (see, for example: Adiel 1996; Beatty, Chamberlain & Magiolo 1995; Petroni 1992; Moyer 1990).

2.3.4 *Other incentive categorizations*

Beneish (2001) has categorized earnings management incentives based on income increasing vs. income decreasing. He lists some incentives for income increasing earnings management as debt contracts, compensation agreements, equity offerings and insider trading. He also presents incentives for possible income decreasing earnings management and includes increase future compensation, obtaining import relief, avoidance of wealth transfers and decreasing earnings during union negotiations or during periods preceding management buyout.

As already discussed one important type of earnings management is income smoothing in which managers try to generate steady earnings. The motives for income smoothing are usually connected to managerial contracting (implicit and explicit) and capital market motivations. Trueman and Titman (1988) argue that income smoothing lowers a lender's assessment of the profitability of bankruptcy and reduces the cost of borrowing and enhances equity value. Fudenberg and Tirole (1995) consider that managers smooth earnings in order to keep their jobs and avoid interference. Kirschenheiter and Melumad (2002) state that a company receives a higher valuation if a possible positive earnings surprise is dampened and spread out over consecutive time periods because investors perceive steadier earnings as more permanent.

In general, Gunny (2010) states that given the inherent difficulty in identifying earnings management without knowing the manager's true intention, one criticism of the literature is that any earnings management identified may result from an omitted variable or may be capturing behavior other than intentional manipulation.

2.4 Case studies on earnings management

As already stated, earnings management literature concentrates on statistical research based on large-scale analyses. There are a few exceptions and here my focus is on case studies. There are some case studies on earnings management that usually relate to extremely fraudulent earnings management, such as Enron

etc. (see, for example: Jorissen & Otley 2010; de Jong, DeJong, Mertens & Ros-enboom 2007; Arnold & de Lange 2004; Hayes 2004; Benston & Hartgraves 2002; Lev 2002; Baker & Lys & Vincent 1995). Generally, these studies demonstrate that both earnings numbers and balance sheet numbers were manipulated. The above mentioned studies are also based only on publicly available data.

However, the case study by Jorissen and Otley (2010) used both public as well as internal company data.³² They analyze financial misrepresentation³³ in two connected major European airlines, Swissair and the Belgian flag carrier Sabena, which both filed for bankruptcy in 2001. Moreover, an investigation report, undertaken at the request of the administration of the SAirgroup, points to the presence of the unfaithful representation of economic performance in the accounting figures. Therefore, their case is an example of fraudulent and extreme earnings management, or financial misrepresentation. Jorissen and Otley (2010) seek to analyze and explain how such misstatements came about. Their data consists of archival data and several interviews with some of the ex-management team of both airlines. Compared to this study, their analysis is based only on *ex post* analysis. However, their study has relevant implications for this study.

Jorissen and Otley (2010) state that financial misrepresentation has usually been analyzed using large-scale empirical research and that the generality gained from such an approach is at the cost of understanding the rich and complex nature of financial misrepresentation in real organizations. Thus, they adopted a case study approach to gain more insight into the incentives embedded in contracts which trigger decisions to engage in financial misrepresentation and the underlying elements of discretion in those processes. They find that these relationships are a black box in most financial misrepresentation studies. In addition, all definitions of financial misrepresentation (including earnings management) point to the central role of top management in such decisions. However, accounting literature has not taken into account heterogeneity among top managers and its possible impact on financial misrepresentation. Therefore they examined the process of financial misrepresentation from an integrated (multiple incentives and multiple methods) and a dynamic perspective. The multi-theory perspective explicitly considers the central role of top management in choosing to engage in accounting numbers management. They analyze the case data in two phases. In phase one they analyze the data through an accounting literature perspective. However, not all the observations of the first phase can be explained by the accounting literature. Therefore in the second phase they examine the data through

³² The case study by Wilson and Shailer (2007) is based also on internal company data but the empirical period was 1910–1965.

³³ As already stated, they use the term financial misrepresentation, since they find that it is broader than earnings management.

the management theory perspective in order to generate additional explanations (Jorissen & Otley 2010).

Their findings demonstrate that in order to understand the decision processes of managers it is necessary to distinguish between the negotiable and non-negotiable contracts of the firm. They observe that the discretion of the causation assumed in the agency framework (i.e. contracts influence behavior) is often reversed in the negotiable contracts (i.e. managers influence contracts). Their findings also provide insights into a number of additional variables which enlarge the discretion of a senior manager to engage in financial misrepresentation. The manipulation of accounting figures can be achieved by many mechanisms which traditional methods based on accruals would not detect. They demonstrate that financial misrepresentation or earnings management can involve decisions in all management areas including financial statements, narratives in the annual report, the composition of the top team, decisions about organizational structure, division responsibilities, the management control systems, investment decisions and operating decisions. Jorissen and Otley find that current accounting research has overlooked perspectives important for a better understanding and explanation of managerial incentives for engaging in earnings management and the underlying processes triggered by this decision. In general, they provide evidence that a deeper knowledge of the characteristics of the CEO and of the factors that determine the distribution of power among corporate managers is required to advance knowledge of financial misrepresentation or earnings management (Jorissen & Otley 2010).

2.5 Summary and implications for this study

As it is presented, there are different definitions for earnings management in the literature. The differences especially relate to the perspectives and the scope of the earnings management definition used. With regard to perspectives, some studies see earnings management mainly as fraudulent behavior that violates accounting standards, whereas some studies consider earnings management to include the use of the flexibilities that accounting standards allow. In addition, some find that earnings management behavior can even be informative.

With regard to the scope of earnings management, prior literature has strongly focused on accruals management. Earnings management measurement literature is still strongly focused on different accruals models, although their reliability and validity is widely questioned. In those studies earnings management is considered a straightforwardly measurable concept, which is usually similar to the conceptions used in earlier studies using similar models. However, I find that the use of such models demonstrates how unilaterally earnings management is con-

sidered. In addition, there appears to be a wide variety of different methods for earnings management. I think that this variety should be more properly taken into account in earnings management literature and thus a more comprehensive analysis of earnings management is needed.

This short consideration leads me to the main purpose of this study: "What is earnings management?" Broadly it seems that mainstream earnings management literature supposes that earnings management is concept that can be directly measured from financial statements. Furthermore it seems to assume that there is a clear distinction between managed and unmanaged earnings and that there are some neutral earnings that are unambiguous (e.g. Ronen & Yaari 2008; Dechow & Skinner 2000). In addition, it is straightforwardly assumed that the managers unilaterally and unambiguously know their firms' unmanaged earnings (see, for example: Evans & Shidhar 1996). These assumptions are inherent for the positivistic nature of mainstream earnings management literature that requires that earnings management is unambiguously measurable based on financial statements.

However, according to Hines (1988; 1991) economic reality depends, at least to some extent, on people's conceptions, in other words, the economic reality that people construct. Furthermore, the picture is essentially much more arbitrary than has previously been stated and the figures in the financial statements are not unambiguously true. This suggests that there is a need for a more subjectivistic analysis of earnings management. Therefore, in line with Hines (1988; 1991), this study takes into account the fact that economic reality depends, to some degree, on people's conceptions of reality. In addition, it further develops the idea that earnings management is a concept that is more open to dispute than prior literature has assumed. This requires a method that analyzes earnings management comprehensively in a firm-context and therefore this study is a case study.

I adopt a broad view of earnings management in the sense that it includes large amounts of different methods (see: Ronen & Yaari 2008; Francis 2001). That broad view could be seen also in Jorissen and Otley (2010), although they talk about earnings misrepresentation. However, I find that earnings management includes balance sheet management and disclosure management as well, which means that financial misrepresentation can be seen as part of earnings management. In general, earnings management has a negative tone and sometimes it is referred to as extremely fraudulent behavior. I argue that directly violating the accounting legislation is an extreme case of earnings management and that earnings management is also practical behavior in which managers make different decisions and use their discretion and interpretation within the limits of the accounting legislation to achieve one or more objectives. In that sense, my point of view is similar to Graham et al. (2005) who state that many executives are not talking about violating the GAAP or committing fraud, but "running the game", in a manner to produce smooth, attainable earnings from year to year. Generally,

I agree with the popular and widely used definitions for earnings management presented by Healy and Wahlen (1999) and Schipper (1989).

Also Jorissen and Otley (2010) have adopted a broad view and demonstrate different methods for earnings management in their case study. My study continues on the path laid by Jorissen and Otley (2010) by using a methodology that diverges radically from the mainstream. Similarly to Jorissen and Otley (2010), I also use a case method, have internal archives and conduct interviews. However, there are a few substantial differences in my analysis compared to their study. Jorissen and Otley (2010) have an *ex post* analysis of earnings management or financial misrepresentation focusing on an extreme case in which illegal and fraudulent actions were conducted and in which even bankruptcy was an issue. Thus, their starting point, including the selection of the case study company, was that a clearly extreme earnings management would be analyzed. In contrast, my study concentrates on the actual process of preparing corporate financial reports by analyzing earnings management *ex ante*, during its making and *ex post*. In addition, my case selection is neither based on any earlier extreme earnings management behavior nor is such behavior a prerequisite for my case analysis. Thus, compared to Jorissen and Otley (2010) this study is expected to be able to produce new insights and perspectives as well as reveal processes behind earnings management that have not been studied before.

3 EMPIRICAL ANALYSIS

3.1 Introduction to the empirical section

3.1.1 *Structure of the empirical section and presentation of the case company*

The structure of the empirical part of the study is as follows. The introduction of the empirical part includes the presentation of the case company, a list of the major and most relevant discretionary accounting items of the case company, a presentation of how the discretionary issues are generally handled in the company and a description of certain disclosure issues in the company. The main empirical part itself consists of five different illustrative stories that demonstrate discretionary behavior. Partly the subjects for the stories emerged from the initial careful analysis of the company's internal propriety data and public financial reporting data that I acquired when I was becoming acquainted with the case in order to understand its key discretionary issues. Partly the stories emerged from the interviews as well as those times when the company faced new situations, for example, difficulties related to business activities or overall market conditions. These stories appeared to be very relevant and they include different situations in which substantial discretion and interpretation by the management was required and in which also the potential for earnings management issues could be seen.³⁴

The story of *adopting conservative accounting methods* (3.2) describes how and why the company adopted conservative accounting methods. The story of *constructing financial reports* (3.3) presents considerations of how the financial reports are constructed and what kind of earnings management issues arise. This also includes the kind of effects public investor guidance and incentive schemes have on constructing financial statements. The story of *an R&D expense activation* (3.4) presents how the company decided to conduct an R&D expense activation and what kind of implications that had. The story of *acquisitions* (3.5) is a presentation of discretionary allocation issues and earn-out issues that were considered when the case made acquisitions. The story of *goodwill impairment testing* (3.6) relates to discretionary issues in goodwill impairment testing. That in-

³⁴ Numerical information about the case company will not be presented.

cludes many types of discretionary behavior and issues such as the levels and the parameters for test.

The above mentioned stories are not all-inclusive, in other words, they neither include all kinds of discretion in the company nor are they presented chronologically from quarter to quarter. In addition, the point of the stories is not to present a large list of factors that affect or may affect discretionary behavior. The point of the stories is to demonstrate and highlight different situations and "hot potatoes" in which managerial discretion is present and in which earning management may occur in different forms, while supporting the purpose and the research questions of this study. I have tried to keep the stories rather short and simple and focus specifically on the core issues of this research. The stories are descriptive and I have let the data and the interviewees talk. The findings are discussed in relation to prior earnings management literature and reflected on in chapter 4.

The case company is a Finnish public company that is listed on the OMX Nordic Exchange, Helsinki. The consolidated financial statements of the company have been prepared in accordance with IFRS, and they follow the applicable IAS and IFRS standards, as well as SIC³⁵ and IFRIC³⁶ interpretations. The notes of the consolidated financial statements have also been prepared in accordance with Finnish accounting legislation and corporate legislation, which complements IFRS regulation.

Initially, at the beginning of the empirical scrutiny I conducted, the case company (referred as the group, company or firm) had experienced very rapid growth both organically and through substantial acquisitions, and the growth was expected to continue into the future. In addition, effort was expected to be placed on growth and further development of the business was expected to occur in the future. Such strong growth entails challenges to any company's administration and especially to its financial administration. For example, many new accounting methods had been adopted due to the development and expansion of the business of the case company. The consideration of implementing new accounting methods and refining existing accounting methods thus requires substantial consideration from management and that has implications for earnings management issues. There were also some clear incentives for earnings management, for example, incentive schemes and public investor guidance issues, which, in the prior literature, have been found to be important motives behind earnings management behavior. In the initial interview, the CFO stated that the flexibilities that the IFRS offer are and should be used. He found using them a natural and practical thing and admitted that he quite actively used to use managerial discretion as laid down

³⁵ Standards Interpretation Committee

³⁶ International Financial Reporting Interpretations Committee

according to the IFRS, in order to meet some thresholds. To sum up, the case company seemed very fruitful for this research.

In the middle of my two years of empirical analysis the company changed its CFO. I refer to the initial CFO as the previous CFO or as the CFO(p). The current CFO and the CFO(c) are used synonymously. The previous CFO was also interviewed after his resignation.

3.1.2 Discretionary issues in the case company

3.1.2.1 Major discretionary accounting items

Based on my analysis, the major accounting related discretionary items relate to:

- Recognizing income from constructing contracts (i.e. stage of completion method)
- Provisions for employee bonuses
- Provisions for guarantee work
- Activation of R&D expenses in the balance sheet
- Extraordinary items
- Allocation of acquisition costs
- Goodwill impairment testing

The potential for earnings management relating to these items includes revenue recognition, timing issues, accruals choice, accounting method choice, choosing to adopt a certain standard, allocation issues, aggregation choices and classification choices. In addition, disclosure issues including, for example the amount of detail provided in the description of the accounting items is intertwined with these discretionary items.

3.1.2.2 Actors

The CFO is the key person for considering discretionary accounting choices and executing them. The financial manager³⁷ operates according to the CFO's guidance and does not take his own view on issues related to major discretionary choices. However, he has a good knowledge of the figures and where they come from. Unit controllers are responsible for certain provisions and they discuss with the CFO and with the respective unit managers, although they do not make any

³⁷ During the first year of my empirical year the financial manager also acted as a controller for business unit A.

substantial accounting choices. The CFO also discusses the choices and methods adopted with the unit managers. The management team that comprises of the CEO, the CFO, unit managers and a few other key managers also discusses some general level accounting choices. The CEO's role is quite distant from that of the CFO's. Both CFOs stated that the CEO concentrates on operational issues but that economic issues are clearly their responsibility. In addition, during the empirical analysis it appeared that neither the audit committee of the board nor the board itself could really challenge the discretionary issues that the management had command of, which is something that was also strongly emphasized by the interviewees. Thus, with respect to accounting discretion, the roles of the audit committee of the board and the board appear formal.

In practice, the CFO, especially the previous CFO, highlights the discretionary issues and discusses them mainly with the controllers and financial manager and sometimes with unit managers. If the CFO finds that the auditors' opinion is needed, he will ask for it. Discussions with the CEO are mainly relevant when new accounting methods are adopted or some guideline changes are conducted. The previous CFO discussed such adoptions more with the CEO than the current CFO has. That is probably because there were larger guideline setting issues during the previous CFO's time and therefore he needed to seek the CEO's approval. The current CFO has quite rarely discussed accounting related issues with the CEO. However, both CFOs emphasize that when they discuss an issue with the CEO they already have a ready proposal and opinion on how the issue should be handled. Thus they mainly try to convince and give arguments to the CEO as to why and how discretion should be conducted or how a certain accounting method should be used or adopted. The CFO(p) states that he can demonstrate, for example, what earnings are generated with and without managerial discretion. In addition, the CFO(p) states that the CEO has to be aware of the discretionary accounting decisions that have been taken and especially how to answer any questions asked about the accounting choices made. The CFO(c) emphasizes that his job is to take care that they will not be in trouble as a result of some discretion decision. The CFO(p) also argues that it is important how the decision is communicated to the audit committee and to the board. Above all, the managerial discretion has to be justified to the auditor; every interim report is scrutinized by the auditor in the so called interim report inspection.

The CFO(p) openly states that he quite actively uses discretion and the flexibilities that the IFRS allow. He undertook to achieve some margin, or as he refers to it, "the CFO's back pocket," in order to use managerial discretion over earnings and to keep the result close to the target budgeted for. Here it should be emphasized that nothing was done to break any rule in the IFRS.

There are legal methods for that. The target is to be able to manage one or two quarters to some desired level and then hope that the business will have normalized. (the previous CFO)

He states that the discretion should be conducted carefully so that investors will not perceive it. The CFO(p) also has experience of earnings management behavior, according to IFRS, from his prior job in which an older executive had taught him how to create a buffer for maneuver. He refers, for example, to the stage of completions that were discussed several times with project managers, the provisions for bad debts that sometimes were made on slightly stricter and sometimes looser criteria and “big bath behavior”, which occurred when everything went wrong in the business and he wrote off anything from the balance sheet that was possible to write off.

The CEO’s attitude appears to have been strictly against flexibilities and he emphasizes that everything always has to be conducted according to the pre-determined principles that have been accepted by the company and that they cannot deviate from them. Discretion is used but it has to be based on the best estimates and it has to be in accordance with pre-determined principles. In addition, he finds that there is not much discretion available. Generally, compared to the previous CFO, the current CFO is more conservative and careful. He does not use flexibility as actively as the previous CFO and he finds that flexibilities should not be used for such intentional earnings adjustments.

3.1.2.3 Disclosure issues

Public investor guidance has been much discussed by the case firm. Initially public investor guidance consisted of non-numerical estimates about the growth in turnover and the operating profit. However, although the company considered that it had given very positive and strong estimates of the future in the annual financial statement, that positive estimate was not reflected in analysts’ estimates. The analysts’ estimates were poor and pessimistic compared to the company’s own estimates. The analysts’ ability to value the case was widely criticized inside the company and management considered that the analysts had conducted very poor work despite the public guidance of the company. The CFO(p) has also commented on the analysts’ reports in order to correct the analysts’ clear errors.

The CFO(p) found that the company was systemically and substantially undervalued in the stock market compared with the company’s own estimates and compared with the valuation of the company’s rivals that used numerical public guidance. The rivals were valued according to their numerical public guidance.

The case company was valued according to much lower growth expectations in the analysts' calculations. However, the company had experienced strong organic growth and also the case company had given guidance that the growth was expected to continue strongly. Thus the CFO(p) concluded that the large information asymmetry between the company and the markets was a severe problem and he especially found that the company was considered too risky. He concluded that the only way to diminish the gap was to start issuing numerical public guidance. At first the CEO was reluctant to approve the idea, however the CFO(p) convinced him. The company's board was strongly against numerical public guidance. The reason for the board's resistance was that the board was afraid that numerical public guidance would lead to profit warnings.

We really hate giving profit warnings, especially negative ones.
(The chairman of the board, in a board meeting)

The CFO(p) demonstrated to the board that a much higher valuation level would result if company's internal business estimations were taken into account and those numbers transferred to the analysts' estimates.

For some reason the board have wanted the company to be very imperceptible and for some reason we have only focused on our customers and we have believed that if we do good business then the investors will realize that. Now that road has ended and we have an interest to be correctly valued in the market. (the previous CFO)

The CFO(p) states that in order to avoid profit warnings the company had previously given only vague estimates, but that had led to a situation in which the analysts' estimates are poor and the risk premiums high. He emphasizes that despite the vague public guidance the company had earlier announced profit warnings, for example, a year earlier it gave one negative and one positive profit warning.

...the company is able to produce good estimates. However, if some surprises occur, they cannot be foreseen and then the profit warning has to be given whether or not numerical public guidance is given... Therefore, some vague verbal public guidance will not prevent the board from being forced to give a profit warning if some radical surprises happen. (the previous CFO)

Eventually, the board agreed that numerical public guidance was necessary, and it decided that the company would start numerical public guidance at the beginning of that financial year. They announced numerical turnover and profit estimates for the quarter and for the year. After the numerical guidance was published, the analysts reviewed and corrected their estimates.

The CFO(p) states that regarding interim reports they always tend to discuss whether or not to give profit warning with the board and the numerical guidance increased that discussion intensity. The CFO(p) always tried to explain to the board that he has already calculated the figures and that there is no need for a profit warning. He criticizes the board for wanting to publish more conservative and vaguer public guidance in order to avoid negative profit warnings. In fact, in some cases they have modified their estimates in order to officially achieve the public guidance estimate that the board made. The board is said to loathe negative profit warnings and said they should never be announced, but the board finds that a positive profit warning is a good thing. The previous CFO finds that the board does not understand that the positive profit warnings is also a profit warning and it does not give a good picture of the company for the markets if positive profit warnings are the rule.

In general, management has considered widening disclosure politics further in order to diminish the company's risk premium on the market.

It is good to inform more, but sometimes I think that are we trying to be number one in reporting ... our auditor wants more and more information, because some other firm has also reported more. (the previous CFO)

The CFO(p) considers reporting to be sometimes more a choice of words, in other words, what is told and especially what is not told. Some information, such as some liquidity problems that are not very flattering, will probably not be published in their original form. He also strongly emphasizes the importance of good internal estimates in order to produce proper numerical public guidance. Previously the internal estimations were quite poor, and no special effort was put into them. However, currently the business unit managers have put special effort into making their estimates correct and not systematically pessimistic nor optimistic. The previous CFO underlines that internal estimation affects big decisions, such as large investment decisions, and asked if the company is willing to make some investment when its effect on the bottom-line result in the short-run is negative.

However, at the beginning of the next accounting year the CFO(p) left the company and the company abandoned its numerical public guidance and reverted to non-numerical based public guidance. The initiative came from the CEO and the reason was that market visibility was weak due to large uncertainty in the

markets and because the company was about to experience organizational change and the changing of its reporting segments. Hence, forecasting would have become too difficult.

That was CEO's initiative and it is easy to believe that the board clapped their hands and agreed with him. (the previous CFO)

The segment reporting issues have also been intensively considered in the company and they were changes twice during this study. Originally, in the beginning of the empirical period, there were two segments. However, in principle they internally followed three segments and the auditor commented on that, which meant that in the following year they had to change the segments. The CFO(p) had a large disagreement with the CEO about what the new segments were and how they could be justified to the auditor. The CFO(p) states that the new segments were very artificial and the official reason was related to the “income generating mechanism”. However, unofficially the company wanted to obscure certain customer and profitability related information. That segment partition was widely criticized inside the company as it did not represent the true segments that are internally followed. Therefore, after one year they again changed their reporting segments under the current CFO, who also criticized the previous year's segments for being “virtual segments”.

3.2 Adopting and using conservative accounting methods

The company had some problematic construction contracts which meant that profitability plunged and some became loss-making. Management pondered what could be done about the problem from the point of financial administration. The CFO(p) suggested adopting a new kind of stage of completion method in recognizing turnover from construction projects³⁸ and a totally new provision i.e. a provision for guarantee work.

The stage of completion method is based on estimates of a project's income and expenses, and on the determination of completion progress. However, initially the method was quite aggressive and the income was recognized linearly in proportion to the completed working hours. Therefore, if faced with a problematic project, they would have been forced to conduct some dramatic loss record-

³⁸ The stage completion for a specific contract is defined as the percentage of completed working hours at the time of review in proportion to the estimated total working hours, and as the share of the costs due to work completed at the time of review in proportion to the estimated total costs for the project (Company's financial statement).

ings.³⁹ In fact, the auditor had remarked about that because he thought the income was being recognized too aggressively.

The CFO(p) suggested adopting a very conservative stage of completion method in which only small part of the total income of the project is recorded as income at the beginning of a project. Thus the greatest share of the income would be recorded at the end of the project and using that method would create a buffer against project delays etc. The management team discussed the percentages of the stage of completion and there were different interpretations about the correct level. Initially the CFO(p) proposed an even more conservative method, however, the business units resisted that because that would have caused a substantial temporary deterioration in their profitability. According to unit manager B:

[The stage of completion method.] *It was just adopted. First an even more conservative method was proposed but I said that was not ok. And then it was changed. Now we have some method... that we have all accepted but it is totally based on our interpretation and it does not have any factual justification. The original proposal was too conservative, but we had no historical information about what the correct level should be. However, we should not be too conservative. ...What is the background for this [method]... Well, I don't know..., I don't know... I actually don't know. The model was implemented by the CFO. I don't think that it is bad, but it temporarily distorts our figures... I suppose that the principle of conservativeness is the main reason.* (unit manager B)

Thus the correct level for income recognition appeared to be highly interpretative and dependent on an actor's conceptions. The eventual method was then approved by the auditor who considered it reasonable.

The initiative for adopting a provision for guarantee work was also taken by the previous CFO. It appeared that the company had no prior experience of guarantee work and initially the people in the business units stated that no guarantee work is conducted at all. The CFO(p) finds that the reason for that initial denying of having any guarantee work at all is a misconception of what is actually included in guarantee work. In addition, people usually want to underestimate the amount of guarantee work, because guarantee work has the connotation of correcting your own mistakes. Later on, the field line managers and unit managers estimated (based on experience) that the correct amount for guarantee work is some 0.1–0.5 percent of the total invoicing. Despite the estimates from the field,

³⁹ If the total costs of a project are likely to exceed its total income, the expected loss is immediately expensed (Company's financial statement).

it was decided that the amount of the provision for guarantee work should be set to 4–5 percent and that in very risky projects it could be even more. The percentages can then be lowered if the original appears to be too high.

The main reason for starting to implement these very conservative methods is that the company wants to secure the situation in which some projects would fail and avoid the dramatic loss recordings that ensued from the aggressive revenue recognition. Thus the company wants to create a buffer against bad realizations. However, the CFO(p) states that he has intentionally adopted new accounting methods that are very conservative, but also very discretionary, in order to enable management's discretion over earnings and to create a CFO's back pocket.

...as projects proceed the provision for guarantee work can be lowered or, regarding to the stage completion method, the working hour estimations altered... and then the percentages or estimations can be changed if needed or if the situation changes. (the previous CFO)

Thus the conservativeness creates a buffer and extends the CFO's back pocket. Naturally, all managerial discretion or methods have to be justifiable to the auditor.

We can always discuss how much we can recognize turnover or what is the correct level for some provision etc... Using our calculations we can always justify the changes to our auditors. It is always easier to start very conservatively and then change the percentages or estimations if needed. The conservativeness creates a buffer that can be used very easily if necessary. The auditor approves conservative methods very easily. Everybody is happy if we are conservative and everything goes fine and if no guarantee work is realized. For example, if we have made a four percent provision and in the end it appears that the guarantee work is zero. That is the point of being conservative. (the previous CFO)

The amount of projects that are at the stage of completion is increasing and the company is learning how to handle such projects. The previous CFO's idea was that conservative methods are used, especially in this early phase. When they have learned the issue and when they have a lot of projects they then can change the method to one that is not so conservative. Currently the system is constructed so that each project is self-sustaining, in other words, if the project is going to be drawn out, the highly conservative income recognition and large guarantee work

will offset that. The CFO(p) emphasizes that this is totally his construction and his idea.

No, the board has no part in that. They do not understand these issues, ha ha! When we discussed that in the management team, the CEO did not speak out. So it is between me and the business units. Now, if we have to manage our earnings up or down, I can discuss whether the estimated working hour estimations are correct. When the estimated completion rate is increased that will generate more income and that also works in the other direction. It should be noted that all the estimations are just as correct as the others and they are only one person's views about what is right. We can also change the provision for guarantee work, which will be a very interesting issue in the future. (the previous CFO)

In some projects they have different percentages and they are set case by case.⁴⁰ Afterwards the CFO(p) stated these project management issues were his construction and a totally new system.

Probably that had the largest monetary value and was the easiest instrument to use. I had access to them because I had developed them and discussed them. (the previous CFO)

After his resignation the previous CFO emphasizes that when the new methods are used the discussion concentrates on whether some particular provision rate, or something else, could be changed. He demonstrates that, if there is need for some discretion in company level, he can discuss with unit controllers as to whether there are some projects in which the estimations are probably too high or low. Then the controller checks the projects and he may respond that there, in fact, are some projects, in which the percentages are too high or low and then they are modified. The unit controller may also contact the CFO(p) and state that in some projects the percentages are quite large, even too large and ask if they could be changed.

⁴⁰ After about a year, the company again changed the systems for the stage of completions and for the guarantee works provisions. The instructions became more detailed and the projects were more systematically analyzed because they had become more common. Generally, the methods became even more conservative than earlier because there were certain large loss-making projects, therefore they wanted to create a buffer against bad realizations.

Then I ask what is the value in money? Or can you divide it and take half now and the other half in the next quarter? Or I make some other suggestion. (the previous CFO)

Controller B states that he had decided to ask for guidance from the CFO(p) regarding stage completions and guarantee work because the CFO(p) developed the methods and gave the instructions. The CFO(p) emphasizes that the financial management will not interfere with the units' provisions or projects' estimated working hours, rather these changes are always discussed with project managers and with unit managers because they have the best estimates of their own projects. However, he has in certain large projects given directions to slightly decrease the estimation of total working hours, in order to reach the higher income recognition level. The change in the working hour estimation is trivial, although it may generate substantially more income. And obviously, if some changes are conducted, they have to be prepared to explain the changes to the auditor. However, the auditor does not have as good information about the projects as the company and its business units have. And that's why the auditor is often of the same opinion as the company – if the explanations are good.

Broadly speaking, the change of the stage of completion method and the implementation of the guarantee work provision are considered to be substantial changes in the company, and they were strongly promoted by the previous CFO. The financial manager states that there have seldom been such large guideline settings.

The method for provision for employee bonuses is also purposefully conservative in order to avoid unpleasant surprises. The CFO(p) finds that the provisions for employee bonuses are almost totally discretionary within the quarters, but adds that they should reflect the expected realization of bonus measures. Hard figures can easily be put into the bonus measurement model, but there are qualitative bonus meters, and thus the management's estimation of the correct provision level is far from obvious. In consequence, there is a lot of flexibility to be used.

And, in the end, to some degree, it is total elastic band what is put in the bonus provisions, because we can interfere with the provisions of some unit, certain personnel, business unit, or the all personnel. For example, we can increase those people's bonus provision from 5 [%] to 6 [%] and generate this kind of additional expense, or then we select those people and lower their bonus provision from 7 [%] to 6 [%] and thus increase our profit this much, and so on. So, we can choose an amount and then decide whose bonus provisions are changed. (the previous CFO)

The above quote shows that the bonus provisions are very important and even minor changes may have a substantial effect on earnings and on the profitability percentage of the company in a quarter. However, the bonus provisions can only be managed quarterly.

The CFO(c) says that he himself does not use the flexibilities so actively and instead uses conservative methods only in order to avoid negative surprises i.e. he uses risk management. The conservative methods accumulate buffer, but that relates to uncertainty about the projects and, although it would be possible to enter the buffer as income, he will not do that. Thus, he does not prefer to use the buffer as a leeway. The CEO also regards conservativeness as a risk management tool.

To sum up, this story has highlighted how certain conservative accounting methods are adopted and used. The methods are actively discussed as all the actors can have different incentives to prefer certain methods. This story also demonstrates how conservative methods create potential for earnings management. However, the use of that potential is highly dependent on the actors and their attitudes to using accounting discretion. In addition, it widely highlights the interpretative nature of the relevant estimates that are needed when using accounting methods. It was demonstrated that the estimations are actor-dependent and that correct estimates are not unambiguous.

3.3 Constructing financial reports

3.3.1 Actors' views

Generally, the CFO(p) has outlined the process of constructing the profit and loss account and the balance sheet so that so-called natural profit is first calculated. The natural profit is a first draft in which no managerial discretion is conducted. Second, he analyzes what the market expectations are, what the public guidance is and what is required, for example, what are the target turnover and target earnings. Third, he analyzes what tools are available for managerial discretion and what kind of flexibility or "CFO's back pocket" is available according to IFRS rules. Then he analyzes the tools for managerial discretion and their effect on turnover, costs and earnings. Then he tries to operate in an optimal manner in order to achieve the desired target.

What do we want our turnover to be? Ok, we want a bit more turnover. Ok. By managing that and that we can increase our turnover

a bit and our result is changed by that much. But we do not want more result. Ok, then we conduct this, this and that and our result stays there. So, in a manner of speaking, after the natural result, we construct the result. Of course, there are certain limits and we have to have justifications. (the previous CFO)

Thus after the calculation of so-called natural profit, the profit and loss account and the balance sheet is constructed, according to the IFRS. Also the financial manager states that they will first produce the draft version or the so-called version 1.0 of the interim report or the annual financial statement. That is checked analytically to see if all the figures and ratios are at the right level. If there appears to be something unusual or some figures differ substantially from what was expected they then analyze it and try to find the reason for that. When that analysis is completed and if they realize that the profitability is weaker than expected, they then check to see if there are any possibilities to improve it.

Naturally the classic question that the CEO asks of the CFO is: "What is our result?" And the CFO asks: "What would you like it to be?" If version 1 of the interim report is ready and we realize that it is too good or too bad, we consider how to make the result better or worse. Then, of course, the first thing to consider is the provision for employee bonuses, which is the natural solution. Or if the profitability is better, we then check if we can invent some costs or transfer some costs or revenues. Of course such issues are pondered in a certain manner, such as: "Are all the entries made correctly?" But I consider it to be more about finding errors and exceptions to explain the figure, rather than to trying to find possibilities to change the figure. We have double-checked certain issues and made sure that the calculations will end up balanced and that everything is correctly entered, and correctly valued. Thus in some cases we do more checks and make sure that everything actually is correct and in line [with the IFRS]. (the financial manager)

The financial manager states that there are always situations that include discretionary calculations that are analyzed and double-checked. If they are incorrect, they will be corrected.

The current CFO does not use the available flexibilities as actively or purposefully, rather he tends to operate quite straightforward and if the calculated result does not match the estimate, he will try to find the reason for that. He argues that if they are talking about true and fair view being communicated to the market, it has to be conducted straightforwardly. He does not give support to the construc-

tion of the CFO's back pocket and he does not want to construct any leeway, because then he would be reporting too low a result. He thinks that is a question, about how straightforward you want to conduct and present your results and that it can be CFO-dependent. Nevertheless, he regards CFOs as being on thin ice if they believe a buffer would be a useful.

Because I am in charge of that, how the result is measured... I don't want to alter the measurement system so that I could keep the temperature at 37 Celsius if needed, even though there is a fever. That is quite short road – in the end; I don't think that it is sensible. ...So it is a personal choice and related to the preferences of each CFO as to how much you allow yourself to alter the result. (the current CFO)

The CEO finds that the possibilities for constructing the result are limited, if they want to operate according to the pre-determined principles. All discretionary items have to reflect the best estimations made at the time of the review and all have to fit into the pre-determined principles that are open and that can be followed retrospectively. And if some discretionary item is changed there has to be a justification for that and the justification has to be in accordance with the pre-determined principles.

I would say that our financial administration produces the result and the turnover by pressing a button. After that... we make sure that it is accordance with our principles. Then we may consider whether there is some discretion or game zone inside which the result can be modified, so that the result is in accordance with our principles and consistent with our previous methods. Next we check to see if that result is accordance with our public guidance. If it is that is good, if it is not then we have to announce a correction to our guidance. (the CEO)

The CEO argues that only real operational activities are possible and acceptable when dealing the accounting figures, and that the normal management of the result entails business-related activities. For example, such activities include making the business activities more effective by increasing sales. However, when using such actions the current CFO states that the result cannot be influenced in the short-term because, for example, if a R&D project is not started or it is shut down, they would still have the same people working in the firm and thus the costs cannot be influenced in the short-term.

The CFO(p) confirms that the CEO seems to think that the result is improved by increasing turnover. However, with regard to managing business related activities, the CFO(p) considers the issue more pragmatic and finds that there are more efficient methods for increasing profitability by decreasing costs and leaving turnover unmanaged. The previous CFO believes that neither the CEO nor the business unit managers have understood or interiorized the idea that the costs can also be managed. In fact he has suggested it. He finds that they understand the turnover and its effect on the result, but they do not understand that there are much larger, quicker and more effective ways to increase the result by reducing costs in order to increase the profitability percentage.

The CFO(p) states that especially during this particular year (i.e. the first year of the empirical period) the discretion over costs is more relevant because turnover is above the public guidance, but there are profitability pressures. Thus in the fall their attention was drawn to some larger costs and this delayed some projects that were transferred for the following year. He refers to a very large internalization project that they delayed because they thought they had no resources to do it. He states that the internal estimation indeed had an effect on that, and he calculated different investment scenarios and demonstrated how their profit would look under these scenarios. They decided that there was no point in investing due to the profitability problems and then the CEO proposed that the management team should not propose that investment to the board.

3.3.2 The concept of the CFO's back pocket

As stated the CFO(p) has tried to map different alternatives to use managerial discretion and to increase the possibilities to use managerial discretion, or as the CFO(p) states, "to create the CFO's back pocket". However, he is convinced that the CFO's back pocket can function properly and that managerial discretion can be used efficiently only when all the modifiable items which can affect the firm's results are known. Therefore, the CFO(p) emphasizes that it is important to understand all the items influencing the profit and loss account and the balance sheet. However, the business units are mostly familiar with their own provisions and estimates, and therefore this is a big challenge, because the financial administration is not familiar with all the modifiable items and other important items that affect the company's earnings, especially in the business units and in the acquired companies. The CFO(p) in reference to Q4 argues that currently too many surprises arise because he is not aware of all the items in the business units, such as provisions or issues in the acquired firms.

[If there are hidden items in acquired firms or in business units] *then we will experience such surprises and I don't like that at all. I think we should be familiar with all the modifiable items etc. I should have all modifiable items known and all possible discretionary items on the table. These are all the possible items, these have been already entered, these are probably not entered but they may have to be entered in the future, these we may have to cancel, these make our profit better, these decrease our profit, in other words, this is the whole bundle that we play with. Then the CFO's back pocket comes into operation when all the modifiable items are known.* (the previous CFO)

The CFO(p) emphasizes that they should not go too far with earnings management and believe that the future will always be successful as that might lead to the temptation to do things that are not right. He argues that those involved in financial management are mainly responsible for earnings management issues, but that some issues have to be discussed with the CEO. However, if he is going to make interpretations about their guidelines or some changes for provisions, they do not specifically talk about that. Rather the CFO(p) may state that he has certain possibilities for managerial discretion and that he can generate a better result if that is preferred.

I can visualize the result to show that if it [the item] is entered into this quarter, the result is better and looks like this. If it is entered into next quarter, the result looks like this and it is good for opening the next quarter. (the previous CFO)

The CFO(p) also refers to the treatment of extraordinary costs that the company had in Q1, in the beginning of the empirical period of this study. The company announced in advance the estimation of a substantial amount of extraordinary costs that would be realized in relation to a certain process and that those costs would be allocated to Q1. They further classified some of the previous year's extraordinary costs as Q1 costs, thus increasing the Q4 result. Also some Q2 extraordinary costs were moved to Q1 because they were easy to justify and because large extraordinary costs were expected in Q1. Generally, the company does not report minor extraordinary costs, but they are reported as normal business related costs. However, if the "account is open" due to some substantial extraordinary items, as was the case in Q1, then some minor extraordinary costs are also classified as extraordinary costs and all such costs are allocated to that par-

ticular quarter. If the account is not open, then the minors are considered as normal business expenses.⁴¹ The CEO states that all the extraordinary costs that were allocated to Q1 were related to the initial large process and he did not want them to be allocated to Q2. The financial manager states that they estimated the amount of the substantial extraordinary cost to be bigger rather than smaller because they do not want to publically estimate too small a cost. This conservative estimate made it possible to transfer some additional extraordinary cost from Q2 to Q1. Naturally this allocation and collecting of extraordinary costs also made the operative figures look better.

3.3.3 *The importance of meeting the public guidance*

The CFO(p) regards public estimates as very important and says it is crucial to meet the turnover and profit targets. The most important issue is that turnover and earnings are in line with the public guidance and that if the company is falling behind with its public estimates, “they will leave no stone unturned”. In such situations managerial discretion should be used in order to meet the targets. However, it is also important that the guidance is steady when compared with quarters in the previous year and that there should not be large fluctuations so that a certain quarter is much better than the previous year’s corresponding quarter, which is then followed by a quarter which is much worse than the previous year. Hence, the former CFO, taking into account normal fluctuations between quarters, argues that the company strives for certain turnover growth in comparable quarters from year to year and believes the guidance should also demonstrate that.

Our guideline is that we prefer stability in our financial numbers relating to sales and profit. No doubt, our quarters are very different to each other and thus our financial figures vary a lot. But, taking into account this normal variation, we want to be stable. We always consider what the implications for the next quarter are when we give figures out in the current quarter. We really want to give public guidance, and particularly give guidance that we are able to meet and if we are not able to meet our guidance, we have to have a very good reason for that. (the previous CFO)

The CFO(p) states that the accounting discretion is indeed used in order for the company to be able to meet its public guidance, i.e. to avoid profit warnings.

⁴¹ Later, during the empirical period the company did not report any extraordinary costs.

For example, a controller may ask about when or how certain discretionary item should be entered, and then the CFO(p) carefully checks the guidance and analyzes what the alternatives exist. However, the CEO states that the income statement and balance sheet are what they are, and states that at the end of a month or quarter they can no longer be altered. He considers all kind of purposeful accounting discretion very unpleasant and unnecessary. Profit warnings are given if the realizations are not in line with the estimations because they can do nothing about that.

The CFO presents his proposal but if someone would propose to me that we should change the bonus provisions, my first question would be: "Why?" And if somebody would answer that we need a 0.5 % better result that would be the wrong justification. (the CEO)

The CEO emphasizes that public guidance has nothing to do with the accounting procedures of the operations inside the game zone and that they do not modify the result in order to meet targets. The IFRS guides all reporting and they have not discussed whether the results should be steady or whether it is bad that it fluctuates monthly, quarterly or annually and how that would affect financial administration. He finds that they cannot manipulate the turnover, because it is based on invoicing, which is based on the working hours conducted and costs, which are what they are. He finds that the only possibility is to make decisions that affect real activities, and after the accounting period is over nothing can be done.

The unit B controller states that numerical public guidance causes substantial pressure for the estimates to be correct also inside the business units and that the unit managers have put serious effort into that. For example, certain provisions in business units are conducted more accurately and the amount of errors allowed has been emphasized. When one month's turnover was estimated too high it was "tracked with dogs" to find out why it had been so poorly estimated and whose error it was. Also the financial manager states that numerical public guidance causes a lot of pressure and that there has been some unfortunate manipulation in the estimation processes when the estimates has been slightly above or under the public guidance, because the numerical guidance leaves no room for interpretation.

The new CFO finds that it is naturally important to meet the public guidance but not by creative fair means or foul. If the result seems to be below the public guidance, they go through all the provisions, stage completions, and so on, and the CFO sends an email to all the relevant people to check that everything is correctly conducted and on the correct level.

And by using them we can in the short-term affect the result. (the new CFO)

The financial manager believes that for the CFO(p) it was more important to meet the public guidance than it is for the current CFO.

...if some goals are not met [the name of the current CFO] would just realize that and try to find the reason for why the goals were not met, but [the name of the previous CFO] would probably have tried different ways to meet the goals. So there is a difference in approach... (the financial manager)

After his resignation the CFO(p) reveals that when he was initially preparing the annual report figures there were discussions about whether to publish a negative profit warnings due to the poor profitability. However, he suggested that no profit warning should be published because there were many possibilities for flexibility.

Later, in the middle of the latter year of my empirical period the company published a nominal positive profit warning due to the fact that they were performing a bit better than announced earlier. The CFO(c) states that they discussed with the board if would it be possible to avoid that. They considered the possibility of decreasing the profit.

...have certain items been calculated correctly and is there something that is missing that could be taken into account ...or I mean is there something that should be taken into account? (the current CFO)

The financial manager states that certain issues were checked more carefully, and some minor modifications were conducted. They double-checked all the provisions and made sure the income recognitions were correct. Eventually they changed the management's bonus provision, which was increased. Thus they lowered the result. That was simple to justify because of the better performance.

...when we realized the situation, we started to analyze issues that were reasonable and that related to the reporting period,... the substantial conservatism principle. But not in the way that we would have started changing the rules of the game in order to decrease our profit. (the financial manager)

The current CFO also states that they considered writing off certain R&D activation from the balance sheet, however they did not conduct that.

The next question would have been: “Why in hell is that whole amount not impaired, if we see that it has no revenue expectation?” I promise in every interim report and in the annual statement that - unless we especially state otherwise - we consistently follow our reporting principles. And if we have concluded in the annual financial statement that the project can be activated in the balance sheet, and we have not reacted to that at the beginning of the year, and now suddenly announce that its value is not that but some [other lower amount], then the question will arise: “How can we justify the rest of the activation value?” (the current CFO)

He states that naturally it would have been possible to decrease the profit even more, for example, to conduct a much larger bonus provision or write off the whole R&D activation, if they had wanted. However, there were no proper justifications for such adjustments. He finds that there is a difference if they meddle in the accounting principles that they use from year to year, unless they especially inform otherwise. He argues that they cannot change the rules of the game in the middle of the game, because that would be unfair to all investors and other parties.

...if not others, but at least we inside the company would know that we have published an incorrect result. (the current CFO)

3.3.4 The influence of bonus incentives and decreasing profitability

3.3.4.1 Annual financial statement

The latter half of the first year of my empirical period culminated in weakening profitability and it was intensively discussed what the profitability percentage was going to be with and without depreciation from acquisitions. The profitability pressure resulted from the extraordinary items, the low profitability of the acquired companies, and the depreciation of intangibles from the acquired companies. It seemed that the bonuses were not going to be realized because the profitability percentages were going to be too low. However, the CFO(p) mapped his

“CFO’s back pocket” and realized that there was the potential to increase earnings. In particular, there was potential to conduct R&D expense activations,⁴² affect the stage of completion of certain projects and to substantially reduce the percentage of a provision for guarantee work of one major project. The amount of the discretions considered was substantial and each would have increased the yearly profitability percentage by a few to several decimal points. However, before any decision was made, the CFO(p) resigned. In the end, the R&D activation was conducted, however the suggested change in the particular guarantee work provision did not occur and only some of the stage completion issues were conducted.

At the end of the year there were substantial bonus incentives. But the financial manager constructed the result and he had no such bonuses. I would have calculated the result more carefully... some income recognition etc... and then I would have realized that “by chance” we just achieved the certain earnings target limit, ha ha! (the previous CFO, after his resignation)

The financial manager, who acted as the CFO during the construction of the annual financial statement, states that they discussed the guarantee work provision, but they decided to stay with the original percentage and that some bonuses were not earned because of that entry.

If a large bonus is realizable when profitability is 10 [%] instead of 9 [%], there are of course differences [in the accounting practices.] But if there is not such incentive, I would rather make my life easier and conduct everything as straightforward as possible. So, I want to keep the balance sheet as clean as possible and if something is activated in the balance sheet, we have to have a good justification for that – we should not begin to start manipulate. And if I am in charge of financial accounting and somebody starts pushing or directing some entries saying “let’s enter this...” and the only purpose is to make the profit to look better. Then we have to discuss that for a long time before will I accept that, because, in the end, I am the one who discusses it with the auditor. All exceptions always give rise to the question “Why?” “Why did you do this?” It is always bad when some bonuses are close to being earned – then there will be some incentives to use some gimmickry because it is about a large amount of money. But when we deviate from the orig-

⁴² The R&D expense activation is discussed in 3.4.

inal method it is always questionable and it is a bad thing. But, sure we can always justify it to the auditor. (the financial manager)

The CFO(p) states that they froze large investments and some minor projects were not conducted. He also presented the discretion issues to the financial manager who continued constructing Q4. In addition there were some items that were entered in Q4, although the previous CFO thought they should be entered in Q1.

These were also such items that would have made it easier to increase earnings and meet the targets. I would have used them to increase earnings. (the previous CFO, after his resignation)

Thus it is evident that the CFO(p) would have conducted the annual financial statement differently and reported a better result. There were certain modification possibilities and it appears that not all the modifications agreed with the business unit managers were used.

It is possible that when they realized that the goals were not achieved they blew for full-time and the modifications were transferred to the new accounting period. (the previous CFO, after his resignation)

If the above mentioned discretionary issues had been conducted, the management would have received substantial bonuses. Now their bonuses were much smaller.

3.3.4.2 Bonus discussion

There was a long-lasting, intensive discussion about group managers' bonuses. Already in the fall the CFO(p) noticed that the bonuses were not going to be realized due to profitability problems⁴³. Hence, the group managers and particularly the CFO(p) proposed to the board that extraordinary items and depreciation from intangible assets should not be taken into account when calculating the earnings that the bonus is based on. It was thought that if the above mentioned items were not included, the operational profitability would be very good and the company would substantially outperform the profitability level and the group managers would receive full bonuses. However, if the above mentioned items are included,

⁴³ The bonuses were tight to the turnover level that was easily achievable; and to the profitability that they were not going to achieve.

the company would not meet the profitability target meaning that only small bonuses would be paid out to the group managers, including the CFO(p) and the CEO.

On the concern level, let's say, I would have increased our profitability percentage by a few decimal points and then we would have got more bonuses and the board would have had no reason to interfere regarding how the bonuses are paid. So, I wish I had conducted the annual financial statement. Now it will depend on the board's benevolence. (the previous CFO, after his resignation)

The CEO is aware that the ground for managers' bonuses is not optimal; however, they do not consider their bonuses during the accounting period.

...it has been realized that in our company management works first and after that considers its bonuses. (the CEO)

However, it was apparent, already in the autumn that the business unit people including unit managers were going to receive substantial bonuses, because the above mentioned items were not allocated to business units. The previous CFO states that the items should be allocated to the business units because they receive the benefit from them. However, the CEO wanted to consider all such costs as company overheads and therefore the business units seemed to generate an outstanding result. After the CFO(p) had resigned, the bonus case remained unresolved.

This bonus case has been extremely difficult for the board and for the CEO and it has been discussed since autumn and nobody wants to commit oneself on the matter. Everybody says "let's see". So, first we will see what happens and then it is decided and I think that is a bad method. The bonus plan itself does not commit itself to that and sometimes not all factors can be included beforehand. (the previous CFO, after his resignation)

He refers especially to the allocation of acquisition costs and that he was directed to minimize the increase of goodwill by allocating as much as possible to depreciable items, which he did. This method naturally decreased earnings due to larger depreciations. However, one criterion for the group managers' bonuses is profitability. Therefore there seems to be an incentive for managers to conduct their estimates regarding the allocation of acquisition costs, so that they would

increase goodwill and not increase depreciation and thereby increase profitability in the short-term.

In the end, the board rejected that proposal and therefore the group managers' bonuses were quite low. The CEO finds that the board correctly stated that the management conducted the decision regarding the extraordinary items and proposed acquisitions, and the management has been very well aware of what kind of implications these decisions will have. He also states that it was an operational management decision to minimize the goodwill in the acquisitions and that there was no disagreement about that, despite the fact some other companies have taken a looser view, i.e. recognized less tangible and intangible assets, which has resulted in less depreciation.

In general, compared to the CFO(p), the CFO(c) is not that aggressive in using accounting discretion in order to maximize his bonuses. He states that in such a case he would know that he has stolen from the company, however, he considers that a personal issue.

3.3.4.3 Decreasing profitability in unit B

In the autumn of the first year of my empirical period, there were substantial profitability problems in sight for business unit B. The controller of business unit B noticed income smoothing being used in the business unit.

Some income smoothing is clearly pursued – within IFRS limits. Or let's say we want to be prepared for the rest of the year so that everything is conducted correctly... I have to calm the situation and state what is not allowed. In our business unit we have discussed how we can prepare and make Q4 seem not as bad it appears. Is there anything we can do? (the controller of business unit B)

They received a government grant for their R&D project in Q3 and the unit's managers pondered whether it would be possible to start its revenue recognition in Q4. However, the controller found that it belonged in Q3.

Also the CFO(p) noticed that the unit clearly aspired to increase its Q4 profit already in Q3 because their Q4 seemed to be very poor. The unit suggested transferring personnel costs from Q4 to Q3 using a certain provision for future holidays. However, the CFO(p) did not find that a good idea and it was not possible to do. The controller states that he inquired about the allocation possibility from the CFO who confirmed that it was not possible.

They considered if there were any costs that could be allocated already to Q3, for example, some provision so that Q4 would be better. It was nothing illegal, but some... some seeking for leeway... But nothing was done...(the controller of business unit B)

The CFO(p) states that partly the suggestion arose because people in the unit did not remember how the provision system works. However, he will very carefully analyze the provisions in Q4 in order to improve the profit. He states that the unit also proposed a large provision for employee bonuses in Q3. However, the company-level performance in Q3 was already quite poor and there was not sufficient leeway to make such transfers. If the company's profit would have been above the public guidance given and if there had not been profitability problems, then they could have considered making the suggested provision.

The controller argues that the reason for these above mentioned proposals was that it appeared that Q4 was going to be bad and therefore the business unit sought some flexibility. However, he points out that the unit managers are not always aware of what is possible or allowable, so they ask about that.

That is not pressure but inquiries about the possibilities, from my point of view. (the controller of business unit B)

The controller argues that it is common that they try to achieve steady results. However, he has quite a narrow point of view, because the major discretionary entries are conducted by the CFO and the controller is not aware of those.⁴⁴

To sum up, this story broadly demonstrates discretionary issues in constructing financial reports. It especially highlights the actors' views, the point of view for their different conceptions and how they regard the public guidance and bonus schemes. This story demonstrated that there are large differences between actors in how they consider and use the accounting discretion the IFRS allows. Furthermore, it shows the effect of public guidance and bonus schemes on actors' behavior when they construct financial statements. In certain situations, rather intense discussions and interplay between the financial management and the business units take place with respect to how accounting discretion is to be used. This story demonstrates that accounting discretion and how actively and purposefully it is used is highly actor-dependent.

⁴⁴ Eventually unit B conducted the particular R&D expense activation discussed in 3.4.

3.4 R&D expense activation

Initially the company did not conduct any R&D expense activations of its projects. However, during the first year of my empirical analysis the company decided to conduct such activations in late spring when business unit A started a certain project which was immediately activated in the balance sheet. The financial manager states that this accounting method change was substantial and that such changes are quite rare.⁴⁵ However, there is no mention about that activation in the interim reports; the total amount of the activations can only be seen in the next annual financial statement.

3.4.1 *The delayed timing of the activation*

In Q4 there were discussions about an R&D project for business unit B and the possibility to activate it on the balance sheet. The project was started during Q2, although it was not activated at that time. The CFO(p) states that the R&D activation was one of the items that would have increased the profit quite a lot.

It was one of the items that could have been modified if we had wanted our result to look different. It was on that list. (the previous CFO, after his resignation)

The CFO(p) admits that he does not really know whether or not the project is really an R&D project that fulfills the IFRS requirements for activation. The biggest question is why it was not activated earlier and why it was activated when it was, in other words just in the annual financial statement.

The project was launched at the end of Q2, so it should have been activated already in Q3. However, the activation started late in Q4. It was discussed a lot: “Can the activation be conducted? What are the justifications for the activation and how is the activation to be conducted?” Especially the justifications for the activation had to be presented to the auditor, as is usual. (the previous CFO, after his resignation)

The financial manager had a very skeptical attitude towards that activation:

⁴⁵ Another large guideline setting was the adopting of the new stage completion method and the provision for guarantee work.

This R&D activation in Q4 was not a good thing. However, it got the go-ahead. I said, "Ok, but you who are ordering me to do that activation, you are going to go through it with the auditor. I don't want to have anything to do with this" They said 'ok,' and then it went ahead. (the financial manager)

The financial manager compares the activation in business unit B to the activation that was conducted earlier in business unit A. In business unit A it was immediately and initially discussed and decided with the auditor that the project was going to be activated in the balance sheet because it fulfilled the activation requirements.⁴⁶ However, the R&D project that was launched in Q2 in business unit B was not initially even considered for activation.⁴⁷

It was later in Q4, in December or even January when they in business unit B had an insight and realized that business unit A was conducting activations of its own project. Then they thought 'We have this kind of project, why are we not activating it?' (the financial manager)

It was widely discussed with the business unit whether there were justifications for the activation and how it should be conducted and how the activated costs were determined. Initially, the CFO(p) proposed an even larger amount be activated in the balance sheet, resulting in much disagreement. However, eventually they agreed on the principles for conducting it.

Of course the activation percentage could be 75 or 100 but we decided that it is 75, because we do not want too much activation on our balance sheet... Of course some could have thought it differently. Naturally the auditor has to approve it and he is naturally an important framework setter. Normally we first ask for guidance from the auditor and then he tells us the method that he will accept. (the financial manager)

The financial manager emphasizes that there are clear rules in the company on how to handle the activation of R&D projects. However the discussion concerned the fact that this activation was conveniently discovered in late Q4.

⁴⁶ As already stated the financial manager also acted as a controller for business unit A.

⁴⁷ They received government grants for both projects.

The auditor was naturally quite skeptical about the activation and the first question he presented was naturally: “Do you have some other grounds for this activation except for trying to increase your earnings?” (the financial manager)

The financial manager states that they constructed the activation justifications, in other words, the calculations and the management’s view that is always based its estimates. They presented them to the auditor, the auditor considered that they fulfilled the IFRS criteria and then the activation was conducted.

The issue is will the project generate profit in the future in order to compensate for the allocated cost. But no way can the auditor say whether or not there is demand for some product in two years. And when the management states that there is demand for the product, then the activation is conducted. (the financial manager)

The previous CFO emphasizes that it is important to prepare and to be prepared to present official justifications to the auditor for discretionary items, although the unofficial, i.e. the real reason, is known inside the company.

The auditor can sometimes see the real reason, but if the justifications are ok, then the discretion is ok. (The previous CFO)

The activation increased the yearly operating profitability percentage by several decimal points, and thus the amount was very substantial. It naturally increased the bonuses for managers, especially in business unit B. The decision to conduct the activation was made by the management team and it was approved by the board. The CEO finds that the reason for the sudden activation was that the nature of the project was altered to become a real R&D project.

Well, when the nature of the R&D changes from the common development work that is normally conducted together with customer work to a specifically definable development project that has its own team, time schedule, own plan, expected results and budget, and even outsider financing, then the project is activated in the balance sheet in accordance with the rules. (the CEO)

The financial manager considers this R&D activation to be a very exceptional entry, though it was accepted and retrospectively conducted. He considers the justifications for the activation, as follows:

Well, it was... well, there is probably the unofficial and the official version. The unofficial is that we increased our earnings by [the money value]. The official version, that is at least partially true – ha, is that we had two quite separate business units. One of which was already conducting an activation, although the other was not, and it was almost not aware that such an activation could be made... but we should use similar methods in our business units. Well, let's say that, at least partly, the reason was that there was this profitability pressure and we actively explored issues that would have been entered wrongly or double-entered and all provisions were quite carefully analyzed... Some issues we found and this was one of the biggest. The auditor accepted it and then we entered it. (the financial manager)

Earlier in the same year, before there were any profitability pressures, the unit B manager stated:

There are a lot of interpretative issues. For example, we have not conducted any R&D activations in our business unit. In the other business unit there are and will be such activations. But we in our business unit have not discussed activating anything and we have no need for that, but the other business unit has conducted some activations, and that is okay because they have these new projects. But we don't have any, especially because we don't have any profitability pressure in our business unit, so why would we conduct some activation? If some profitability problems would arise, then we have to consider that because that is one device. But...is it self-deceiving or the truth? Probably, if there were some temporal profitability problems that could be used... Currently, we have a substantial R&D project on the go and we expect big business from that. And if some surprise occurs and our profitability suddenly temporally falls, then we should, at least, seriously consider conducting an R&D activation. (the unit manager B)

3.4.2 Ex-post analysis of the activation and the continuation project

Already in Q1, almost immediately after the activation in unit B, they started pondering whether or not the R&D activation was going to generate the income that corresponded to the activation. They considered writing off at least part of that activation. The reason was that they received contradicting information from

the field about that project. The people who were conducting that project said that it is fine, but sales and others were doubtful. The management decided to believe the people who were most familiar with the project, i.e. the people who were conducting it. Thus normal activations were conducted in Q1, but after that they decided that the development phase was over and they stopped increasing the activation and the activation will be depreciated normally. They concluded that further development would not be useful. The financial manager states that they did not want to take the risk that after some year or two they would realize that the project was unsuccessful, despite their plans, and that they would have seemingly dug their own grave and improved the result, only to then have to conduct a dramatic write off.

We decided to stop this so called gimmickry... And I think it would be extremely stupid to construct a bomb in the balance sheet by systematically activating, when we know that the activation will be written off at some stage. (the financial manager)

Afterwards, the current CFO criticizes the activation and states that in future the R&D projects will be more carefully analyzed, though he states that he does not know what kind of process was ongoing last year.

Hmmm...well I do not know what the view was last year. But most likely if I had made the decision last year the project would not have been activated in the balance sheet. Fortunately, the R&D activation is an item that will disappear bit by bit. (the current CFO)

He believed already in the spring that the activation was questionable. However, currently in summer it seems that there are future profit expectations. Thus, it has not been written off nor have the depreciations been accelerated, but it has been normally depreciated according to the depreciation plan.

Later, in the summer the prospects of the original project recovered and the company decided to start a continuation project. However, when the continuation project was initially prepared and analyzed the CFO(c) informed the business unit that the project will be recorded as an expense as long as the business unit can demonstrate a plan that demonstrates that development work does have expected future financial benefits. The current CFO argues that it appears that the earlier balance sheet activations were also conducted in projects that ultimately only aim to develop know-how. However, he will not accept such projects being activated in the balance sheet, unless there is clear view that the outcome is expected to bring future financial benefits.

...I did not say to them that we do not make such activations. I said that I want to see the plan according to which the activations are conducted... against which the future revenues are generated, or the future revenues that are now activated. But I did not receive such a plan and so we did not make any activation, ha ha! So, no activations if I don't receive justifications for that activation. I want that plan before I agree to put a project on the balance sheet. I just want the justifications, because they are probably the most problematic issue on the balance sheet and there are substantial IFRS factors relating to them. (the current CFO)

In the end he did not receive any suggestions from the business unit to start activating the continuation project. They will apply for a government grant for the continuation project, but the current CFO states that that is not a good enough justification for activation. He argues that the government grant received for the original project last year was clearly an indication for the starting of the R&D activation discussion. However, he emphasizes that the business units always have the best information about their projects, even compared to the CFO who decides the activation.

In general, the CFO(c) states that there are differences in opinions about how the activation issues should be handled. He argues that they have to have quite a good plan about how the know-how will be turned into profit and says they must have good justifications in order to put something on the balance sheet.

It is a similar problem when we were discussing whether to allocate into goodwill a lot or a few... So, there is a risk that we are constructing a bomb in our balance sheet. Generally, I know that I have to discuss the activations with the auditor. Therefore, I demand groundwork and justifications from the business units...But mainly that is case by case. Typically, R&D projects are such that it is difficult to state exactly what type of project can be activated in the balance sheet, because the projects have different goals. But that is why we are more careful in analyzing them. (the current CFO)

The financial manager points out that although the original R&D expense activation in unit B was questionable; such issues are always quite interpretative.

...I think that if we would get together with some other people we would get different views about it. Some would argue that the activations are correct and others not. But it is about which side you

believe. Well, we have decided that we believe people who are most familiar with the projects and who know the project best and they had the most confidence in the projects. (financial manager)

The CFO(c) states that if he accepts the activation for that continuation project, then the auditor will also most likely accept it. However, the activation issues are not obvious because they depend on the outcome of the project and the purpose of the project, and if the purpose is to purely develop some know-how, then everything has to be recorded as expense. But if they are developing some product platform that can be sold or that can clearly be used in making the production more efficient and it decreases the costs, then it can be activated. He requires a real development plan and a productization plan, i.e. the expected income that corresponds to the activation should be recorded on the balance sheet.

But it is quite clear that I have a stricter view than [the name of the previous CFO] regarding R&D project activation... We have to have a real plan and it is not a good enough argument that Tekes⁴⁸ will pay for part of the project. (the new CFO)

He states that all R&D projects are carefully followed and discussed with the units. He refers to the previous year and states that he does not want a situation, in which a bomb is being built in the balance sheet.

...my view is stricter than [the name of the previous CFO], so, well, well... last year they entered the activation into Q4 and well, well...The question is whether it was conducted in order to receive bonuses or what...well...well...Ha ha! There are different stories about that. (the new CFO)

The CFO(c) argues that the right answer is personal with respect to what he allows to be activated in the balance sheet and what the previous CFO allowed. He emphasizes the importance of the process that has to be gone through first. He considers himself relatively careful regarding activating something intangible in the balance sheet as he requires really good justifications for that. The financial manager verifies that:

The current CFO is more careful about what is activated in the balance sheet than the previous one... I think the last thing that the

⁴⁸ Tekes – the Finnish Funding Agency for Technology and Innovation

CFO [refers to the current CFO] wants is to create some bomb in our balance sheet. (the financial manager)

The financial manager and both CFOs emphasize that it is the CFO who decides what is activated in the balance sheet and that if the CFO decides that something will be activated, the justifications for the auditor are created. However, if the CFO decides that something shall not be activated in the balance sheet, it is not activated.

Absolutely, the CFO decides what is activated in the balance sheet, in the end. (the financial manager)

Both CFOs and financial manager state that they can always produce appropriate justifications for the auditor in order to activate some project in the balance sheet etc.

We discuss with the auditor about the methods, how something is and will be conducted, and what methods we agree to use. Broadly, we know the justifications that have to be presented... How something should be justified in order to use discretion or flexibilities... Well, the auditor has no reason to interfere in that if he receives information from the business units and from the managers that the case is okay. So, it is hard for the auditor to say that it is not okay. (the previous CFO)

At least we can present the calculations and make sure that certain criteria are fulfilled... here are the expected future returns and we have no doubt about their success. ... The most important thing for the auditor is that he will get the documented justifications and then he is happy... if the justifications are ok. (the financial manager)

The financial manager regards the auditor as being quite strict and that he demands justifications. However, if the auditor discusses something with the company's technology expert, who can present, explain and argue the issue convincingly, then the auditor cannot say that anything is wrong. Nevertheless, after half a year or a year the auditor may ask about the situation of the project and if the situation is not acceptable, it has to be written off.

The CFO(c) considers such actions to be matters of personal choice, however, he himself is rather conservative, or somewhere between neutral and conservative regarding accounting issues in order to avoid negative surprises. He finds that in the end the CFO indeed decides the perspective on accounting issues, such

as what is to be activated in the balance sheet. The board does not consider these issues. He underlines that it is his responsibility to take care of the balance sheet.

And in the end it is me who discusses with the auditor about these issues, i.e. what is activated in the balance sheet and on what justifications. People, who do not professionally deal with financial issues, do, to some degree, understand the income and loss statement, but not fully. For example, depreciations are almost always too difficult. But the balance sheet is absolutely too difficult, for example how the income and loss statement and balance sheet are linked to each other. So the circle of people who can accurately consider these issues cannot be very wide. It is the CFO indeed, who determines where we are in that continuum. (the current CFO)

The financial manager finds that the current CFO is stricter on such issues than the previous one and that the current CFO wants to conduct things in a more straightforward manner.

...well I had an impression that [the name of the previous CFO] considered it a personal victory if the company result was good, ha ha! (the financial manager)

At the end of the empirical period the R&D activations were still on the balance sheet and normal depreciations were conducted, and no new activations were conducted by the CFO(c). The current CFO emphasizes that if some activation were to be conducted, it would be the CFO himself who would decide it and it would not be discussed with the audit committee. Thus it is about what the CFO accepts or does not accept, which he then discusses with the auditor. He finds that although the business units participate in these issues, the CFO takes care of them. He points out that they are very difficult issues and that some unit managers do not fully understand them because they have not been forced to consider such issues. He argues that it is very important that there is someone who knows and understands what there is on the balance sheet, and what the justifications for those things being there are; and the CFO is that person. Someone in the business units may consider that activations can be conducted in order to make the profit look good, but that there has to be someone who makes sure that it is conducted properly. However, he states that there are differences between CFOs. In addition, he stated that they would conduct the annual financial statement in a more straightforward manner than they had under the previous CFO.

To sum up, this story demonstrates discretionary behavior that relates to an R&D expense activation. The story highlights how the company ended up con-

ducting an R&D activation with a delayed timing and what kind of discussions and arguments were related to that. The actors' conception about the justification of the activation varied greatly. It appears that there were different arguments for the delayed timing of the activation, including both official arguments and unofficial arguments. The official justifications for the activation were created to fulfill the IFRS requirements so that the auditor could accept the activation. It was widely demonstrated that because the company has an information advantage over to the auditor, it can always construct justifications for the activation that are very hard for the auditor to disagree with. The story clearly demonstrated that there are different conceptions between the actors with regard to R&D activations. Especially, it appears that the two CFOs have differences of opinion about what kind of a project can be activated and what kind of justifications are needed. It also appears that the previous CFO was active in creating justifications for the activation, whereas the current CFO requested the justifications from the business unit involved. However, the story indicates that the CFO is the key player in deciding how these issues are eventually handled. Furthermore, the findings indicate that the issues are highly actor-dependent and open to interpretation.

3.5 Acquisitions

3.5.1 Allocation of acquisition costs

The company conducted two large acquisitions in the first year of my empirical analysis. Both acquisitions include large amounts of intangible assets and especially goodwill and only very small amounts of tangible assets.⁴⁹ The allocations are therefore considered very challenging, in fact, the previous CFO considers the acquisition cost calculations the major discretionary accounting choice.

The whole allocation of the acquisition cost is based on discretion.
(the previous CFO)

It is challenging to identify the intangible rights and to allocate value to them, because they are not very concrete...for example some competition restriction agreements. (the financial manager)

⁴⁹ The determination of the fair value of intangible assets is based on the estimates of cash flow related to the assets, because no information related to the trade of the corresponding assets has been available on the markets. Intangible assets acquired through merging business operations are activated in the balance sheet at their fair value and at the time of the acquisition (Company's financial statement).

The company has used the services of an external advisor in determining the fair values of tangible and intangible assets in all business combinations.⁵⁰ However, the previous CFO emphasizes that the discretion and the input used in these calculations is produced by the management of both the acquirer (i.e. the company) and the acquired company. In this case, the CFO(p) and unit managers mainly produce the relevant estimations that are used in the calculations. Based on the discussions the external advisor gave its proposal, which was discussed and modified several times. The CFO(p) emphasizes that the best understanding and best information is in the companies.

In the opinion of the manager of unit B the IFRS has not brought any transparency to company acquisitions. He also doubts whether it helps investors to better estimate a firm's success. He also finds that it is questionable that the acquisitions currently have such a large effect on the balance sheet and the profit and loss account.

When an acquisition is conducted according to IFRS the valuation of the company is an interpretation that depends on peoples' conceptions. (the unit manager B)

The company conducted acquisitions in previous years and the amount of goodwill was already very substantial and that was considered a risk factor. The management discussed with the board and they decided that calculations for the acquisitions should be conducted so that goodwill would increase as little as possible. Therefore, the previous CFO and the unit managers explicitly made their relevant estimates on the basis of the calculations of the acquisition costs, allowing as many tangible and intangible assets to be placed on the balance sheet as possible, thus minimizing the goodwill. The relevant estimates included many intangible assets. However, the new acquisitions also included substantial amounts of goodwill, since there were only a few tangible and intangible properties that could be allocated to the balance sheet according to IFRS rules. In fact the company became one of the highest firms on the Helsinki Stock exchange measured by the percentage of goodwill to total assets.

Currently the amount of goodwill is very large despite this allocation method of ours. Our starting point was to identify assets we could allocate. (the previous CFO)

However, goodwill would have grown much more if they had considered the allocation differently. For example, they could have determined the length of the

⁵⁰ The researcher has the company calculations of the allocation of the purchasing price.

customer relationship so that it was shorter, such as from ten to four years. That would have decreased the amount of intangible assets and increased the goodwill. Thereby, the depreciations would have decreased and their profit would have increased.

[Such action] would have increased our goodwill and therefore improved our result. However, we thought that we would rather accept the hit to our result than increase the value of our goodwill, as our goodwill level was high, even before these acquisitions. If we had increased our goodwill as much as possible, we would be in top three of all listed firms in OMX. (the previous CFO)

The CEO illustrates the discretionary and the challenge in deciding the length of the customer relationship:

...we can illustrate with our records that this particular customer used to make deals that are 1.5 or 2 years. But we can also illustrate that the work that we do for the customer is such that it will continue in the future. Thus we can expect that the customer relationship will continue in the future if we don't mess it up. ...we really have to think about how long the customership has continued, what is the volume, how long the contracts are and what is the order book. Well, it is hard to make the kind of decision that the customership would continue forever to the end of world. Therefore, we have to end it at some point. And that naturally has an effect on the depreciation time and we have to find some balance. (the CEO)

The CFO(p) has a broader view of the amount of goodwill that is discretionary.

And the amount of goodwill is such an issue that can very easily be set on a very large scale on a certain level, in other words, how much is the goodwill and how much is the amortizable intangible rights? Mainly it depends on what is wanted and we have decided to adopt a policy in which we try to get as much as possible for the amortizable intangible rights and thus as few as possible for the goodwill. Our competitors have not necessarily adopted a similar policy... (the previous CFO)

The current CFO has good knowledge of the IFRS with regard to acquisitions because in his prior job he had to handle several acquisitions. He argues that the

IFRS have entailed good methods for dealing with acquisitions, although the discretionary element is substantial.

In these big issues the discretionary element is much larger and on a different level than earlier. The IFRS have very good guidelines for handling acquisitions, because the goodwill has to be separated from the other intangible rights, and so on. Therefore, in the acquisitions processes, what is bought is more carefully considered... However, the practices in these valuations [refers to the external advisor] are short and there are no established methods for evaluating the effect of different factors. (the current CFO)

3.5.2 Earnings management behavior in acquisitions

Generally, the CFO(p) argues that when acquisitions are made, it is important to optimize the balance sheet of the combined businesses so that it maximizes the result of the acquirer. The profit of the acquired company, prior to the combining date, should be managed down. Thus they explicitly used modification possibilities and transferred all the costs that were possible to consider as belonging to the period before the acquisition to that period, and all the income that was possible to transfer to the period after the acquisition to that period. For the CFO(p) this is a natural and easy operation. This "big bath" also produced gains for the owners of the acquired companies, because the earn-out system was used. The earn-out period started after the acquisition and during that period the potential additional acquisition price was determined based on the performance of the acquired firm. As the result of the acquired company was managed down before the financial statements were unified, the acquired company was expected to generate better profit during the earn-out period. Thus, this method potentially increases the additional purchase price paid to the owners of the acquired company. This method can also be considered positive for the reputation of the company managers of the acquirer since it increases the possibility that the acquisition initially performs well, making it appear to be a good one, at least in the short run.

However, the pre-determined earn-out period may cause earnings management behavior in the acquired company after the date of acquisition. The case company acquired a firm in October, but the earn-out period was said to start in January. Thus there appears to be a clear incentive for the acquired company to manage earnings down from October to December. In fact, the profitability of the acquisition fell after the acquisition, and therefore the company paid special attention to this point. The CEO states that there has been speculation about the matter, but he finds that the acquired company has no possibilities for income

decreasing earnings management. That is because the acquirer takes immediate control of the acquired company, and thus it would be detected if someone would try to transfer some contracts to the earn-out period.

The performance of the latter acquisition (i.e. the acquisition in which earn-out began in January) was very poor in Q4. It experienced some major negative surprises and its result dropped substantially and was far below what the acquisition's CFO expected. They missed the estimated turnover by some 20 %, although the profitability percentage was only a bit weaker. The CFO(p) believes that there are issues that are clearly not in order in that acquisition, that they did not fully understand its business and he also points out that there was no other information source than the owners of the acquired company.

In January I raised a point that the beginning of the year has to be checked very carefully because the earn-out will start on the first of January. So, if there were some project delays in order to maximize the additional purchasing price. (the previous CFO, after his resignation)

He argues that there is a high risk for such manipulative behavior and it would be clearly worthwhile for the acquired company. He thinks that the CEO probably thought that a lag of 3 months is so short a period that nothing can be manipulated. The original information received from the latter acquisition was criticized and, in fact, the CFO of the latter acquisition had to answer to the board of the acquirer (i.e. the company) as to why the performance was so poor and why it did not meet the estimates it had given. He indicated that they had missed some deals and some projects were delayed and it could not be proved that intentional manipulation had taken place.

The result was quite steady in the beginning of the year compared to the end of last year, although that was bad. They had budgeted some projects to the end period of last year, but then they did not win those cases or the cases were transferred or delayed... After January-February their operations have improved and grown as the companies expected. And now they are at that level they were talking about... But no, no special issue has arisen that would indicate some intentional project delay or something of that sort. That idea had been proposed in different forums, but based on the figures nothing indicates such behavior. (the financial manager)

There are also clear incentives for an acquired company to conduct earnings management during the earn-out period, thus increasing the additional purchas-

ing price. In fact, the former acquisition's result was substantially better than expected in the last month of the earn-out period and it clearly conducted income increasing earnings management.

...Well, then we analyzed and "cleaned" it [i.e. the financial statement of the acquired company] carefully and there were some items that were taken out of their result... and we made corrections... We then reduced some of their income recognitions and increased some costs that should have been there. They have clearly increased their profit... (the financial manager)

The CFO(c) confirms that they went through the report very carefully because the earn-out was ending. The company agreed with the acquired company that certain items should be canceled out and the original result was decreased by some 20 %. Despite the corrections the acquisition's result was very good in that particular month, yet the following month was again at its normal level.

To sum up, this story demonstrates discretionary accounting issues that relate to acquisitions. The story of allocating the acquisition costs into tangible assets, intangible assets and goodwill appears to be highly discretionary and has substantial and long-term implications for accounting figures. The management's role, their interpretations and expertise in these calculations cannot be overstated. Thus the allocation is highly actor-dependent and the correct allocation is far from straightforward. In contrast, the allocations are discussed between the companies and inside the acquirer. For example, the acquirer considers the tradeoff as to whether to maximize or minimize goodwill. Maximizing goodwill clearly minimizes the amount of yearly depreciation but increases the risk for goodwill impairment. On the other hand, by minimizing goodwill the company clearly increases the intangible assets and therefore increases the amount of yearly depreciation. However, minimizing goodwill lessens the risk of goodwill impairment. Thus, in considering the allocations, the acquirer takes into account what kind of balance sheet structure it prefers, and tries to optimize that. Broadly speaking, it appears that the potential for earnings management in these calculations is enormous. In addition, the story of the earnings management behavior that occurred during the acquisitions demonstrates that earnings management could be conducted by the acquirer when merging. Also the acquired company could have high incentives for conducting earnings management in order to maximize the total purchasing price, i.e. the wealth of the owners of the company being acquired.

3.6 Goodwill impairment testing

3.6.1 Background

Before the two large acquisitions goodwill impairment testing has not been a special issue in the case firm because the company had no problems with it. The testing result had always been much bigger than the balance sheet values. In the summer of the first year of my empirical period, the financial manager considers the goodwill impairment testing as follows:

...it is a funny calculation because we know the result that we should at least get out of it and I think it is quite an artificial calculation... There are several parameters, for example interest rate, turnover growth level, and we can modify these parameters forever in order to achieve the preferred result. ...we see what the calculations produce and what we want and so we can modify, for example, the growth rate from 5 % to 5.5 %... I think that it [the goodwill impairment testing] is only an obligatory work-out for us and we can conduct it so that we will get the results we want. The limits [for impairment] have never been even close for us and I think that that risk won't exist in the future either – if our estimates and growth rates are realized as expected. We have no problem with it. It is only a calculation that has modifiable parameters that we can manage in order to get the result that we want. (the financial manager)

The goodwill impairment testing can be conducted in the right manner so that it will not result in impairment loss recognition, but that is a controlling calculus. There is discretion, but naturally some framework...It is not so that this number has to be 5, but it can be 5, or 4 or 3, or 6 or 7, but not necessarily 12. So it is a controlling calculation that does not influence our company, unless we are doing worse than expected, which is very unlikely. (the financial manager)

However, the large acquisitions increased the goodwill substantially and the goodwill vs. equity ratio was about 100%. During the annual goodwill impairment testing, the impairments were not close in unit B, even with the higher discounting rate and lower growth estimations. In contrast, in unit A the testing was

a hot potato because both acquisitions were allocated to it and the performance of the acquisitions was significantly worse than expected.

In Q4 the hot potato was the acquisitions conducted in [the year of the acquisition] and the impairment testing and the calculus relating to the acquisitions. The auditor and the audit committee paid special attention to that. (the financial manager)

Those issues were much discussed with the auditor and with the management of the acquired firms starting from the original purchasing price calculation, in other words how they ended up with those calculations and what are the current estimates. In the end there was not much latitude when they modified the acquisition prices according to the new budgets. It was also discussed with the auditor whether there was a need to re-estimate the allocation of intangibles. However they decided not to interfere with those, but the auditor requested that the impairment testing should be conducted in every quarter.

3.6.2 *The levels for the tests in the annual financial statement*

At the end of the first year of my empirical year there was intense debate about how the goodwill impairment testing should be conducted. Previously the goodwill impairment testing was conducted only on a business unit level. Now there was discussion as to whether the impairment testing should be conducted on a more precise level, in other words, should the recently acquired companies be tested separately because they are monitored separately. The acquisitions are part of unit A and the financial manager originally conducted the testing of unit A as a single entity. However, the auditor insisted that the testing in unit A should be divided into three parts since the previous year's acquisitions were followed separately and because their performance was poor. Then the financial manager conducted three separate tests in unit A.

The goodwill impairment test did not indicate any goodwill write-down. However, in the annual financial statement they presented a sensitivity analysis which indicated a write-down in unit A if the parameters (e.g. the discount rate or growth estimates) were changed slightly. They analyzed it very carefully with the auditor, who approved it but insisted that the sensitivity analysis has to be disclosed as the write-down limit was close to being exceeded.

...if the discounting rate was a bit higher, or the future growth estimations that were used in the cash flow estimations were a bit lower...more pessimistic, we would have been forced to conduct

impairment loss recognition. So, we were very close to being forced to make impairment loss recognition. (the financial manager)

However, in the annual financial statements the separate tests of the acquired companies are not mentioned, rather they mention that testing was conducted on unit A and unit B.

These separate tests are not presented in the financial statement, but they were conducted internally. They were not published, but the reporting was based on a segment level. (the financial manager)

Thus, for an investor, it appears that the acquisitions are combined into unit A. The original unit A has done quite well and its cash flow was very positive. However, the auditor stated that the original part of business unit A is ineligible to compensate for the possible impairment of the previous year's acquisitions, regardless of its positive figures, although they were in the same segment at that time. Thus, the potential impairment loss from that year's acquisitions would be recognized fully on auditor's request, regardless of the fact that the rest of the business unit could compensate for it.⁵¹ The auditor thought that they fulfilled the criteria and were separate CGUs i.e. cash generating units.⁵²

The financial manager states that if some impairment loss would have been recognized, they would have reported the levels for the tests more specifically and indicated where the impairment loss came from. But he felt there was now no need for that.

The CFO(p) left the company before the eventual goodwill impairment testing was conducted. Due to his resignation, he is not aware of how the testing was conducted and the separate tests were not presented in financial statements. He states that initially they were going to test the previous year's acquisitions separately, but when they were constructing the budgets for upcoming year the business unit manager reduced the budgets and estimates. In particular, the latter acquisition produced such a bad result in the late autumn that the respective unit manager sketched its future so badly that it demonstrated a loss-making and zero profit for five years and would only generate profit after that. If they had tested the goodwill against those budgets, they should have conducted huge write offs

⁵¹ The CEO and the CFO(c) are aware of the separate tests in the annual financial statements. However, they have the impression that if some impairment loss was recognized from some acquisition, the rest of the respective business unit (i.e. the unit A) could compensate for that. They believe the acquisitions should not be considered as CGUs. The CFO(c) was not in the company yet so he does not know what the company agreed with the auditor.

⁵² The company also made the first segment change at the end of first year, and therefore there were additional discussions of the CGUs.

from the previous acquisitions and the whole company's annual result would have become substantially negative.

...And we did not want to do that. ...when the goodwill is tested according to such estimations it seems that the goodwill in the balance sheet has no justification. Therefore it has to be written off.
(the previous CFO, after his resignation)

The CFO(p) states that there was major disagreement about that and that the CEO and the respective unit managers put forward the view that the goodwill tests and budgets are separate issues and are not linked to each other. However, the CFO(p) thought that goodwill cannot be tested against anything other than the budget of the company.

...of course we have to believe the numbers that we have in our budgets and also those numbers have to be used in the goodwill testing...(the previous CFO, after his resignation)

The financial manager confirms that the testing is based on the budgets and the estimates for future periods and, as already stated, that the testing is conducted separately from the acquisitions. Thus the CFO(p) speculates:

I don't know how they have conducted it. They may have conducted it on a specific level, but they may have used numbers that are not coherent with our budget. Of course we can always show different numbers... but what is then explained to the auditor when he sees the budgets? Well, probably the budgets are not presented to the auditor, or only a higher level aggregate budget, i.e. a business unit level budget is shown, because, on that level, these acquisitions are not separate but inside the business unit. (the previous CFO, after his resignation)

He states that now it appears that the goodwill was tested on a much larger scale and consequently there is not a problem. Thus it is an interesting matter of interpretation what is and should be the specification level in goodwill impairment testing.⁵³

⁵³ In fact, it remained a bit unclear for the researcher what parameters were eventually used in the testing, in order not to conduct impairment recognition. It is possible that the testing parameters have been changed and that they may not have used the unit manager's very pessimistic "revamped" parameters but the better original parameters that the acquired firm estimated.

3.6.3 *Avoiding the impairment loss recognition*

In Q1 the goodwill impairment testing was still a hot potato due to the quite poor performance of the acquisitions, however, no impairment loss was entered. The current CFO states that impairment loss recognition is very close and that even the numbers might indicate a need for a write off. However, he believes that impairment loss recognition decisions should not be made too hastily.

We should not be hasty in making decisions about impairment losses and we have to consider any corrective actions we might have to take. (the current CFO)

He also refers to the impairment testing in the annual financial statement and to the revamped (i.e. the reduced) estimates.

We have to remember that impairment testing is conducted against the future and future cash flows. For example [the name of the latter acquisition] budgets were decreased by the company [the acquirer, i.e. the case company], in other words, the company [the acquirer, i.e. the case company] did not believe, based on last autumn, that they [the acquisition] would succeed so well, but they did what they expected. (the current CFO)

He finds that it would be against the spirit of the IFRS to immediately conduct an impairment loss recognition because it is irreversible.

This [refers to the substantial risk for impairment] should indicate that we need immediate improvement and corrective actions: corrective actions... a new plan, a new estimate after the corrective actions, then monitoring and then the potential impairment recognition. (the current CFO)

In fact, during the spring the company started negotiations with unions about lay-offs and the CFO(c) states that they were corrective actions.

And then we conduct a new estimation and monitor it and if we are not going in the right direction, we have to consider the impairment loss recognition. Thus we should not make an impairment loss recognition decision too quickly, because the situation can also improve and then the impairment loss recognition would have been unnecessary. (the current CFO)

The success of the acquisitions recovered during late spring and there were no more appreciable risks for impairment when the financial manager conducted the controlling calculations for Q2.

So, it now seems that the impairments will not necessarily occur, but that is the risk item in our balance sheet. If the limits would have been closer, we would have conducted more specific tests and then discussed the matter with the board in the interim report meeting. (the current CFO)

Generally, the CFO(c) believed that there was no point in doing separate testing on the previous year's acquisitions because they were quite deeply integrated into the company and the company's intention was to totally integrate those acquisitions and not keep them separate. They were acquired to support business unit A and were not seen as being an independent entity. However, due to the earn-out period, they were still followed separately. The CFO(c), in fact, tried to convince the auditor that the separate tests cannot be conducted because the acquisitions are integrated and the cash flows cannot be allocated on that specific level anymore. In addition, they were once again considering a new segment reporting structure and therefore they were also considering new testable units, i.e. the CGUs.

3.6.4 The parameters for the tests

The CFO(c) states that there are substantial discretion possibilities in determining the parameters for goodwill impairment testing. In particular, the discounting factor (i.e. the WACC) and the growth expectations are discretionary factors that have a significant influence on unit valuation in goodwill impairment testing. He emphasizes that he decides how the discounting rate is determined, what kind of external factors are taken into account and what the growth expectations in the calculations are.

In WACC the issue is: what is the required return on equity? Regarding that anything is possible; I use management discretion for that, in other words, I may correct it. (the current CFO)

The financial manager also ponders whether there are differences between audit firms regarding, among other things, the discounting rate that should be used.

The point for the company is to be able to convince its own auditor where the parameters come from and that is interesting. (the financial manager)

The CFO(c) discusses the WACC with the auditor in order to keep it at the right level and states that the analysts' estimates lay the ground for that. However, he may correct it and then he has to present good documented arguments. It is challenging to estimate the beta for the company's stock, because, due to thin trading, it is statistically only some 0.5 that does not correspond to the risk of the stock, states the current CFO.

Usually we add some risk premiums to our equity in our WACC calculations in order to get some reasonable result. (the current CFO)

He states that in these big issues the discretion used is much larger and on a different level than earlier.

Using the IFRS entails discretion. That opened up a whole new world of discretion. We can discuss different WACC levels for many hours and you would not get me caught for using the wrong WACC level, because there is no right answer. It is my own view of the WACC which is correct. (the current CFO)

He also finds that they can change future GDP growth from 0 to 1.5 % and they will be on a totally different level regarding both the company's value and whether or not to conduct impairment loss recognition.

In big questions there is discretion but the minor details are set quite precisely in the IFRS. I define how we operate and the lower level is never allowed to change it. But on the management level it is totally different. For example, the percentages in our stage completion methods are almost totally discretionary. (the current CFO)

3.6.5 The tests during the financial crisis

At the end of my empirical period the financial crisis had begun. The CFO(c) states that the current market situation is interesting with respect to goodwill impairment testing, because the auditor will argue that the balance sheet value should have a connection to the market value. However, the market value has

crashed but the company's realistic internal cash flow estimations demonstrate values that are over two times higher. The CFO(c) states that the cash flow values correspond to the market value if the discounting rate is set to 25% or if the growth estimations are set negatively for a long time.

This is the issue that has been discussed with the auditor. Is there, in such a market situation, any sense to take into account the market values? (the current CFO)

Naturally, he argues that there is the chance to make a very large impairment loss recognition without considering the cash flow estimates. However, he finds that the situation is absurd because nothing in the business units indicates that any impairment should be conducted. Instead he believes that it is about the question; are the markets always right? If they think that the markets are right, they have to conduct that very large impairment. He, in fact, conducted different internal valuations and none of those different methods demonstrated an impairment loss. He did not find any explanatory factors but discovered that all market values are down and the future is discounted according to a very large discount factor in every company. Therefore, they eventually decided to conduct the goodwill impairment testing against internal budgets. Consequently, there was no need for impairment loss recognition. The auditor accepted that because the situation was similar in many companies.

The impairment loss issue is difficult because we have not yet gone through any stagnation during the IFRS. If stagnation does occur, we may find some common practices developing if many companies have to consider such issues. (the current CFO)

He also discussed face to face with the chairman of the Board about the amount of goodwill and the IFRS statements about impairment. The chairman of the board was worried about the amount of goodwill because it was stated as a risk factor in a financial statement. He asked if the company can do something about that risk and how much it can be impaired if the situation demands it. The CFO(c) also revealed what kind of effect the allocation of intangibles will have on it.

But he asked what we can do about that risk and the answer was: nothing, we cannot do anything and we cannot reduce that risk... (the current CFO)

The CFO(c) explained the goodwill issues to the chairman of the board, for example that the goodwill will disappear only if the company experiences some problems, and then the goodwill impairment will even increase the loss. The CFO(c) states that it is obvious that the board will completely rely on the management's view about goodwill issues and approve the calculus that the management presents. Generally, he finds that the IFRS is still quite new and the regulation changes and especially different auditing offices have different views about the issues and how IFRS should be adapted. That illustrates the substantial differences in these practices between firms. There are many such issues and it is difficult for outsiders to follow.

To sum up, the story of the goodwill impairment testing highlights the enormous amount of discretion that management has to use when considering the issue. The story highlighted that the potential and discretionary behavior in goodwill impairment testing related not only to the testing of parameters, but also to the consideration of the testing units' issues and avoiding the potential impairment loss recognition. Furthermore, in IFRS the testing of goodwill is still rather new and therefore the testing methods are not deeply established, increasing the potential for discretionary behavior. In particular, new situations, such as the financial crisis will require substantial discretion from the management as to whether or not to conduct goodwill impairment. Broadly speaking, the conceptions inside the case company varied a lot between the actors and it appears that the actors' interpretations and their expertise will play a substantial role in considering the goodwill testing issues.

4 DISCUSSION OF THE RESULTS

4.1 Introduction

In this chapter I discuss the empirical findings. As we recall, the general purpose of this study is to open the black box of earnings management, and more specifically to analyze what earnings management is as well as how and why it unfolds and how it is intertwined with the process of preparing corporate financial reports. The following questions were addressed: 1) How can we identify earnings management and its potential; 2) How and why does earnings management emerge and what kind of dynamics relate to that?

Using a case analysis in which the empirical part was a key element, the focus of the research was placed on earnings management and its occurrence in the process of preparing corporate financial reports. I analyzed managers' use of discretion in different situations in which earnings management could occur. The stories from the field offered a considerable amount of different dimensions on earnings management issues. Based on these stories the findings are presented and discussed according to the purposes of this study. In 4.2 I discuss the results related to the methods of earnings management and earnings management potential, including a discussion of the extent and the diversity of the methods and the potential for earnings management; new situations and new kinds of potential for earnings management; the use and the change of earnings management potential and issues related to the interplay of conservatism and earnings management. In 4.3 I present the dynamics or the processes related to earnings management. In 4.4 I discuss the role of actors' and their incentives in conducting earnings management. Some of the issues I discuss have not received much attention in prior earnings management research, especially in the mainstream literature.

4.2 The methods and the potential for earnings management

4.2.1 The extent and the diversity of the methods and the potential for earnings management

This study comprehensively analyzes earnings management and the potential for earnings management in the case company. In line with prior literature (e.g.

Jorissen & Otley 2010; Ronen & Yaari 2008), this study demonstrates that earnings management includes an extensive variety of accounting and business activity related issues and that there are numerous possibilities for earnings management as well as different kinds of earnings management potential inside a company. As Francis (2001) and Jorissen and Otley (2010) imply, there are numerous choices that can be used to manage earnings, and generally the choices are divided into the accounting choices and into the real choices. As stated in chapter 2, the accounting choices are divided into 1) influencing the accounting figures: *accounting method choice, accruals choice, choice to adopt a standard, disclosure choices*; and 2) influencing the presentation of accounting figures: *lay out choices, aggregation choices, classification choices*. The real choices are divided into the *structuring of transactions, production decisions* and *investment decisions*. In general, my case analysis demonstrates most of these choices, i.e. both accounting choices and real choices.

First, with regard to accounting choices, during the empirical period of my research, the case company adopted many new accounting methods such as guarantee work provision and R&D expense activation, and refined certain accounting methods such as the stage of completion method for construction contracts. These adoptions, as well as refinements were the subject of intense discussion between the actors about what kinds of methods could be implemented and different arguments about the level of conservatism of the methods were presented. Essentially, these new accounting methods included substantial potential for earnings management, especially relating to the choice of accruals. The stage of completion method and the guarantee work provision were set very conservatively (i.e. reserves were constructed) and thus they offered earnings management potential that could be used afterwards to increase the profit (by releasing the reserves). Thus earnings management potential in these two issues especially related to revenue recognition. With regard to the stage of completion by affecting the internal hour estimation (i.e. the completion stage) of the project – even trivially – it was possible to achieve the next level for income recognition that allowed the recognizing of substantially more income. Furthermore, the provision for guarantee work offered room for interpretation to afterwards diminish the amount of provision and thus to recognize more income. Both the issues were considered highly interpretative and dependent on the actor's concept of them. In relation to the R&D activation the discussions concentrated on what projects should be activated (classification), the timing of the activation and also the amount of the activation (accrual choices). After the activation the discussions concentrated on whether or not to increase the activation, write-off issues – such as the timing of the write-off, evaluating the justification avoiding the write-off, whether to accelerate the depreciations or not, and whether to activate the continuation project. Thus the R&D project activation required a large amount of dis-

cretion and interpretation from the management, offering much potential for earnings management.

Further, with regard to accounting choices, the provision for employee bonuses appeared to offer substantial potential for earnings management by changing the management's estimate about the correct provision level. There were different bonus provisions for different employees and the qualitative factors made it possible to use more managers' discretion in the estimations. These estimations about the correct level of provision were considered almost totally discretionary and interpretative – an elastic band, as the previous CFO stated. Earnings management relating to extraordinary items focused on classification issues, in other words, what items are classified as extraordinary costs. If the account for extraordinary items was "open", there was potential to use the income statement classification shifting as well as timing, i.e. the ability to transfer small extraordinary costs to a particular quarter.

The allocation of acquisition costs was highly interpretative (not even arbitrary), and required substantial discretion from the management in deciding the amount of tangibles, intangibles and goodwill. Furthermore, goodwill impairment testing offered a large variety of earnings management issues starting from the testing levels, i.e. the aggregation level for testing units. The parameters for the tests were also a hot potato, as was the tests during the financial crisis.⁵⁴

In general, all the above mentioned issues require and also offer substantial discretion possibilities for the management leading to rather intense negotiations between the actors. Giroux (2004) argues that the management of a company adopts a certain perspective on accounting issues and that that perspective can be conservative, neutral, aggressive, or even fraudulent, and that earnings management includes accounting treatments from the whole spectrum. I broadly agree with Giroux (2004) but I would specify that it appears that the starting point for some accounting methods and accounting issues could be conservative, whereas some could be thought to be rather aggressive. Furthermore, discretion includes many accounting choices from the list presented by Francis (2001). I find that these accounting choices are intertwined with each other. For example the disclosure choices are deeply intertwined with the other choices since they are very relevant regarding the amount of details provided in the description of accounting policies or methods.

Second, with regard to real business activities related choices, I find real earnings management related behavior. Certain costs were decreased in order to meet the targets and certain investments were not conducted in a specific year. The previous CFO conducted the investment calculations and convinced the CEO

⁵⁴ Acquisition related issues, such as allocation of acquisition costs, and goodwill issues are discussed further in 4.2.2.

about not to conduct the investment. These issues are highly interpretative and they can also be classified as normal business related activities because they were justifiable. Nevertheless, it appeared that managers' incentives were intertwined with these actions, to some degree.

Broadly my findings suggest that if a company engages in earning management it will most likely use a variety of different methods, and therefore my findings support the statement by Jorissen and Otley (2010) and Cohen and Zarowin (2010) that management uses many methods in conducting earnings management, including accrual-based earnings management as well as real earnings management. I agree also with Gunny (2010) that if a company engages in real earnings management, it might engage in one or more types of real earnings management simultaneously. In general, my findings are in line with prior literature that suggests that future research should focus on real activities as well as accrual-based manipulation (Cohen & Zarowin 2010; Gunny 2010; Jorissen & Otley 2010; Roychowdhury 2006).

The observations above demonstrate the extent and the diversity of earnings management methods and potential in the case company. In order to develop further insight on the issue I more deeply examine the handling of R&D related earnings management topics; an issue that has been much analyzed in prior earnings management literature.

The activation of an R&D expense in the balance sheet naturally increases earnings and prior literature on accrual management has analyzed that. The prior literature also relates R&D issues to real earnings management and most of that research provides evidence of the opportunistic reduction of R&D expenditures to reduce reported expenses (Roychowdhury 2006). However, Seybert (2010) suggests that the capitalization of R&D expenditures could lead to real earnings management in the form of overinvestment rather than underinvestment. For example, a manager who is responsible for continuing an R&D project would prefer to overinvest and capitalize – due to personal reputation concerns – if the reporting regime would otherwise necessitate asset impairment. Seybert (2010) asserts that the overinvestment is partially attributable to non-conscious processes. One such example would be the desire to avoid abandoning suboptimal R&D projects as that would reflect poorly on managers. Hence, they may unknowingly engage in motivated reasoning to conclude that their project will be successful (Tayler 2010; Bloomfield & Luft 2006; Russo, Medvec & Meloy 1996). Seybert (2010) finds that this is in line with concerns that corporate cultures increasingly focus managers on the external reporting consequences of their decisions (Jackson 2008; Duncan 2001; Jensen 2001), and that managers may be hesitant to impair intangibles (Hatfield 2002). Managers who are experienced in dealing with R&D capitalization may be more careful about the projects they select, preferring to avoid future impairment decisions entirely (Entwistle 1999). Managers may

also be able to negotiate with auditors or exercise their discretion in avoiding impairments without investing additional funds in failing projects (Landry & Callimaci 2003). Prior literature suggests that the market may react negatively to R&D capitalization when managers can choose between capitalizing and expensing (Cazavan-Jeny & Jeanjean 2006). Thus, if given a choice, managers may prefer to opt for expensing and avoid overinvestment and impairment problems altogether. However, currently, both IFRS and GAAP require consistent treatment of R&D expenditures and do not allow the manager an explicit choice between expensing and capitalization (Seybert 2010).

Generally, the broad prior literature has provided extensive evidence of earnings management related behavior related to R&D issues, and this study also produces support for the prior literature. For example, it clearly appeared that profitability pressure in business unit B was the impulse for considering the R&D expense activation in that business unit in order to increase earnings. In addition, when discussing whether to write-off the activation, it appeared that the people, who were directly responsible for the R&D project were those most unwilling to accept the possible write-off and different justifications were presented in order to avoid that write-off.

However, this study indicates that R&D expense activation depends on the actors who participate in activation negotiations, the key actors and their conceptions of the issue are especially crucial. This study clearly demonstrates that different concepts about the issues raised are held by those inside the company. Furthermore, there can be different views, even between two people holding the same job, as was shown by the differences between the two CFOs. For example, when the current CFO started in the company, it was decided not to continue increasing the R&D activation discussed above. Later the current CFO also decided that the continuation project will not be activated at all unless the business unit can present proper justifications. It was widely demonstrated that the current CFO's view on R&D activation was substantially stricter than the view of the previous CFO. In addition, the current CFO argued that it is always a case by case analysis – regarding a project – as to whether or not it will be activated and that it is the CFO who decides that. This indicates that, regardless of the IFRS requirements, substantial interpretation is used in considering whether an activation is to be conducted or not, which reveals that these interpretations are strongly actor-dependent. All this indicates that the handling of such R&D expense activations is far from obvious.

Furthermore, the case company had not conducted R&D expense activations in its prior years and did not publish any information that they were planning to conduct R&D activations. In addition, the interim reports during the accounting period do not reveal how activations are conducted, thus an investor will not notice the activations until they are in the annual financial statements. As we recall,

there were two R&D activations during the first year of the empirical period of this study: in unit A starting in Q2, which appeared to be handled and activated appropriately; and another in unit B starting in Q4, which has been widely discussed. In the annual financial statements it was briefly stated that the two different projects were started and activated, however, only the aggregate amounts of the yearly R&D expenditures – the R&D costs included in the financial period and R&D expense activations – were presented in the annual financial statements. It is worth emphasising that the activations are not mentioned in the interim reports.

Hence, in this case, I would argue that if the published financial statements, and interim reports were the only evidence available, then one would only be able to speculate as to whether or not the activations could be considered a manipulated entry and what the unmanaged, neutral amount of the activation would be. A more broad ranging observation is that this study indicates that if the analysis is based only on published financial statements, including annual financial statements as well as interim reports, there is considerable risk of drawing misleading conclusions about the occurrence of earnings management, especially on the company level. Furthermore, the findings of this study indicate that if an analysis is only based on public financial statements, then only cases of extreme overcapitalization can reasonably be challenged. By conducting an analysis based on a large number of completed financial statements and by determining some “normal” level for R&D activations and interpreting that variations from that normal level indicate earnings management, it is then obviously possible to speculate and draw conclusions that, *on average*, for example, R&D expense activations are used for earnings management purposes. However, this study indicates that such a method is to some extent questionable, and on a company level such a method could lead to random and misleading conclusions about earnings management.

In addition, it would be useful to consider what behavior, with regard to the R&D activation in the case, should be considered earnings management. Should it be considered as earnings management when the company did not initially conduct an R&D activation in unit B, although the company had started conducting activations in unit A? The company did not use similar methods in its business units, so should this over conservative behavior in unit B be compared to unit A and unit B looked on as being an example of earnings management? Or should it be considered earnings management when the company suddenly started the R&D activations in unit B? This was when the company abandoned over-conservatism in unit B, and retrospectively interpreted the project as an R&D project that should be activated and then conducted the activations. Or should both issues be considered as earnings management? This would imply that the choice not to conduct the activation as well the activation itself could be consid-

ered earnings management. We have to remember that the choices are always justified and argued inside the company and also to the auditor, as in this R&D case. We could also ponder what would be the amount (the monetary value) of earnings management relating to the R&D activation. Various potential activation methods were discussed between the actors and these different methods would have generated different amounts of balance sheet activations and different amounts of income recognition, i.e. different earnings. It was widely emphasized that all these methods were based on substantial discretion and that they could have adopted a different view. Thus, if it is concluded that earnings were managed in this R&D case, the natural question would be: What should be considered unmanaged earnings, i.e. the neutral earnings in this particular case? Although I conducted a deeper analysis and attempted to discover the reasoning behind the decisions, and despite the fact that the IFRS gives rather detailed directions on how the issue should be handled, I was not able to unambiguously answer that question because the outcome depends on the conceptions the actors have and the negotiations between actors. I could conclude that earnings were managed in this particular case, but the amount of earnings management also requires interpretation, indicating that the concept of unmanaged earnings is far from unambiguous.

Here I focused on R&D activation and demonstrated that the handling of R&D expense activation is far from obvious and it includes a lot of discussion and interpretation regarding discretion. This study indicates that this finding can be applied in many discretionary issues, for example, stage of completions, different provisions and goodwill impairment, etc. Relating to all of these discretionary issues the unilateral conception of the correct level was widely questioned and it was emphasized that the estimations are highly interpretative and actor-dependent. However, based on a deeper analysis this study highlights the broad scale of different discretionary behavior that is available and which could be classified as earnings management relating to the above items. There are differences on how these items are perceived in published financial reports, but all these issues can at least be found in annual financial statements. Therefore, in principal, the statistical models could be able to recognize them. However, my findings indicate that if the analysis was based only on completed financial statements, it would be highly speculative to conclude that those items on the financial statement came about as a result of opportunistic earnings management behavior. I believe that, in order to make such a conclusion, more information from inside the case company is needed. In general, both CFOs consider that it is quite difficult for outsiders to identify some earnings management item – if EM has been conducted carefully, furthermore justifications can always be presented. This could be considered to be in line with Beneish (2001) who finds that if managers have incentives to manage earnings, they are likely to do so in a way that is

difficult to detect, thus reducing the previously applied models' ability to detect earnings management.

Broadly the findings of this study are in line with the literature that has criticized the mainstream earnings management literature for concentrating too much on statistical methods and called for different research methodologies (Jorissen & Otley 2010; Beneish 2001; Fields et. al 2001; Dechow & Skinner 2000; McNichols 2000). My findings give support to the findings by Jorissen and Otley (2010) which reveal that the management of accounting figures can involve all types of financial and management accounting information as well as strategic, investment and operating decisions. They conclude that research methods need to be extended if they are to discover the different types of earnings management regarding the accounting figures presented in their study. This study strongly supports their conclusion, and in addition, taken into account the extent and the diversity of the methods and the potential for earnings management, this study suggests that richer research methods, including case research, in earnings management literature should be used in order to better capture and understand the phenomenon.

Furthermore, my findings indicates that by conducting an in-depth case company analysis I was able to discover earnings management behavior that would have probably been beyond an analysis based only on completed financial statements. If such an analysis were to have been undertaken, it would have been highly speculative and difficult to draw conclusions about earnings management with regard to certain items. More importantly, this case study highlights that it appears that the determination of the unmanaged earnings is highly interpretative. Specifically, this study highlights the interpretative nature of the accounting discretion and various discussions and negotiations between the actors, indicating that the conception of earnings management is, to some degree, interpretative and that a clear distinction between managed and unmanaged earnings is far from obvious. This is broadly in line with Hines (1988; 1991), who argues that reality is constructed and depends on actors' conceptions.

4.2.2 New situations and the potential for earnings management

During my empirical period the company faced new kind of situations that demanded substantial discretion from the management, and in these situations earnings management issues were intensely discussed. First, I discuss goodwill impairment testing and the allocation of acquisition costs. Second, I discuss acquisitions, especially from the viewpoint of the target company.

Relating to *goodwill impairment testing*, the prior literature has focused generally on asset write-offs,⁵⁵ but goodwill impairment under the IFRS has been studied by only a few researchers in comparison.⁵⁶ Jarva (2010) examines a sample of non-impairing firms in which there are indications that goodwill is impaired. He does not find convincing evidence that firms are opportunistically avoiding goodwill impairments. Nevertheless, he finds some evidence that goodwill write-offs lag behind the economic impairment of goodwill. Ramanna and Watts (2009) provide evidence that non-impairment is increasing in financial characteristics that serve as proxies for greater unverifiable fair value-based discretion, although they fail to find evidence that the non-impairment is due to the managers' possession of favorable private information. This study contributes to this literature by indicating that the impairments seems to be avoided by using discretion in testing parameters, but also by using different interpretations of the IFRS. These interpretations of the IFRS, include 1) considering corrective business-related actions to avoid the impairment; 2) trying to affect the levels for the tests, i.e. using the aggregation level to avoid the impairment; 3) considering the issues of whether the tests should be conducted against market values or against the internal estimation – if there is no justification for the low market values due to the extreme market situation, i.e. during a financial crisis.

Furthermore this study widely documents earnings management related behavior and potential that relates to goodwill impairment, which includes managing testing parameters; estimations management and budget management; considering the testable units (i.e. the levels for the tests); avoiding impairment loss recognition by conducting corrective actions; considering whether the tests should be conducted against budgets or against market values. These issues are highly discretionary and negotiable and a management's internal estimations and conceptions are crucial. In addition, the goodwill impairment is usually an item that could destroy the whole annual profit of a company, thus increasing its relevance from an earnings management perspective.

This study demonstrates substantial discretion issues relating to the *allocation of acquisition costs*. However, to my knowledge, prior earnings management literature has not paid serious attention to that. In the case company the allocations were considered the most discretionary and interpretative issue and the eventual allocations also depended on the company's preferences. As stated, the company explicitly tried to recognize as many as possible tangible and intangible assets in

⁵⁵ See, Strong and Meyer (1987) and Elliot and Shaw (1988) for the relationship between write-offs and stock returns; Ahmed and Guler (2007) for goodwill-write offs and stock returns; Alciatore, Dee, Easton and Spear (1998) for a review of the studies on write-offs of long-lived assets.

⁵⁶ Muller, Neamtiu and Riedl (2009) provide evidence that insiders in companies conducting goodwill impairment engage in the abnormal selling of their shares in quarters prior to the announcement of such losses.

order to minimize the increase of goodwill. That method naturally increased the yearly depreciations and therefore decreased earnings. It was widely emphasized that they could have adopted a different perspective, i.e. allocate less tangible and intangible assets and increase goodwill. That would have increased the profit substantially and thus increased management profit-dependent yearly bonuses. However, the risk of goodwill impairment in the future would have increased. It is also worth mentioning that the allocations have a long-term effect on the balance sheet as well as on the income statement.

Goodwill impairment testing as well as the allocation of acquisition costs are issues in which estimates related to fair value measurements are crucial. There is still continuing debate about whether fair value measurements in financial statements are appropriate (Jarva 2010). Opponents of fair value accounting argue that allowing unverifiable estimates into accounting numbers can seriously compromise their usefulness and increase the likelihood of opportunistic disclosure. For example, Watts (2003) argues that the assessment of the value of a firm and its implied goodwill is extremely subjective. Proponents of fair value accounting believe that asset liability measures that reflect current economic conditions and update future performance expectations will result in more useful information for making economic decisions (see: Barth 2006). Holthausen and Watts (2001) argue that fair values, when not based on actively traded market prices, i.e. when unverifiable, can increase the likelihood of opportunistic disclosure. Agency theory suggests that managers will use unverifiable discretion opportunistically (Ramanna 2008). Monitoring and reputational cost can mitigate opportunism, however, Ramanna (2008) points out that contracts are unlikely to prevent opportunism, since unverifiable estimates are difficult to challenge *ex post*. Generally, the standards that rely on unverifiable fair value estimates either increase the management of financial statements or increase the agency costs of monitoring managers (Ramanna & Watts 2009).

In general, my findings are in line with Ball (2006) who found that fair value accounting under IFRS generates increased opportunity for manipulation. My results should be interpreted with caution and they might also be context-dependent. However, they document a huge discretion and earnings management potential. I conclude that the IFRS offers substantial discretionary possibilities and it appears that the practices are not yet established, thus there is even more room for different interpretations. Furthermore, new situations, such as financial crises may require new kinds of discretion. This is in line with Nelson (2003) who pointed out that relatively young standard-setting regimes, such as IFRS, appear more principle-based because they have not had as much time to accrete rules, but over time there appears implementation guidance, interpretations and technical rules, and the standards tend to become more rules-based. Also Jeanjean and Stolowy (2008) point out that the application of accounting standards

such as IFRS involves considerable judgment and the use of private information, and provides managers with substantial discretion. Callao and Jarne (2010) recently found that earnings management has intensified since the adoption of IFRS in Europe, as discretionary accruals have increased in the period following implementation. Their results suggest that the IFRS have unwittingly encouraged discretionary accounting and opportunistic behavior, with a consequent impact on the quality of financial information. They find that these results seem to confirm that principles-based accounting models leave more scope for earnings management (Callao & Jarne 2010).

With regard to *acquisitions*, this study provides evidence of earnings management when merging an acquired company into the acquirer as well as issues relating to the earn-out period. Prior literature on earnings management relating to acquisitions is very thin. Ronen and Yaari (2008) find only three studies that have investigated earnings management by acquirers⁵⁷ and there is no evidence about whether the target firm manages earnings. Erickson and Wang (1999) did not find statistically significant earnings management by target firms. Easterwood (1998) finds that firms subject to hostile takeover attempts will try to manage earnings upward in order to thwart the attempt. This study contributes to that literature by highlighting earnings management issues and earnings management behavior in acquired companies, especially when an earn-out system is used, in other words, when the potential additional purchasing price is paid based on the future performance of the target company. Specifically, before the earn-out the acquired company may have incentives to conduct income decreasing earnings management, if there is a time gap before the earn-out period starts. During the earn-out the acquired company has an incentive to conduct income-increasing earnings management in order to increase the additional purchasing price. It is worth noting that an acquisition appears to be successful if the target firm's earnings are managed down prior to the takeover and upwards during the earn-out. However, this will increase the earn-out payoffs, which leads to real economic costs for the acquirer, particularly if the managed earnings are unsustainable.

Broadly, goodwill impairment testing, the allocating of acquisition costs as well as acquisitions are all issues that companies face. However, in general they are rather unexplored areas in earnings management literature. This study demonstrates that goodwill impairment testing and the allocation of acquisition costs include substantial discretion from management and offer huge potential for earnings management within the limits of the IFRS. In addition, with regard to acquisitions, some earnings management issues appeared to be clearly observ-

⁵⁷ Erickson and Wang (1999) find earnings management preceding the agreement to merge; Efendi, Srivastava and Swanson (2006) and Louis (2004) find that acquiring firms inflate earnings in the quarter preceding the stock swap announcement.

able, or even prevalent. However, all these subjects have yet to be analyzed in-depth in prior earnings management literature. Therefore, taking into account the importance of earnings management potential (especially, the large amount of discretion) and the discretionary behavior that this study indicates, I suggest that earnings management literature should begin to explore the issue in more depth. This suggestion resulted from a comprehensive case analysis that can be considered a building block for future earnings management research.

4.2.3 The use and the change in earnings management potential

Ibrahim (2010) states that it appears unlikely that managers would inconsistently manipulate the components of accruals. For example, the manager does not have the incentive to increase accounts receivable on the one hand and increase accounts payable on the other, which has a dilutive effect on bottom-line earnings. This inconsistent pattern of behavior, if found empirically, most likely captures measurement error in the discretionary accruals measures (Ibrahim 2010). This study strongly supports Ibrahim's (2010) finding about consistent earnings management,⁵⁸ but provides additional insights by highlighting that consistent earnings management necessitates that the behavior is, at least to some degree, dominated by actor. In this study that individual would be the CFO. For example, the conception of the CFO's back pocket indicated that a manager may explicitly map the different possibilities for managerial discretion and then that potential is consistently used if needed. Thus, management needs to be aware of all modifiable items and all the possibilities that can be used. In addition, in certain situations there was a very intense and purposeful search for the possibilities for managerial discretion, such as consistently checking for the potential to increase the result if it was just below some critical threshold. Furthermore it was demonstrated that management may selectively use accounting discretion in a preferred manner. For example, it was illustrated that when profitability was below that which was desired but turnover was over the public guidance, the management (i.e. the key actors) preferred cost-decreasing managerial discretion that increased earnings but left the turnover unchanged. Thus the performance of the company has an effect on the preferred type of earnings management.

The nature of the potential for earnings management relating to the items varies a great deal and the manageable items are used very differently for earnings management purposes when compared to each other. Some items are used main-

⁵⁸ I would like to remark that it could be possible that a company's business units may occasionally have incentives to conduct accounting discretion inside the business units that could be considered inconsistent when compared to each other, or compared to the whole company.

ly in quarterly level earnings management, whereas some items are used in annual level earnings management. During the accounting period, the bonus provision appeared to be a key instrument for earnings management in interim reports. However, they could not be used on an annual level. The stage completions, guarantee work provisions and R&D expense activation can be considered as both a quarterly level as well as an annual level earning management tool. With regard to the above-mentioned items there was potential to both increase and decrease the result. However, the goodwill impairment testing does not include any positive potential, instead there is only a chance to avoid conducting impairment loss recognition. In line with Gunny (2010) the accounting figures were influenced by conducting real business related actions, although their effect was not instant and took some months if not more. Thus, after that particular period, the accounting numbers cannot be affected by real activities but by an accounting related maneuver.

The prior literature has provided some evidence about using different earnings management methods during accounting periods. Generally, it is argued that during the accounting year managers use accruals management to meet analyst' expectations, but since the annual reporting process is subject to a more rigorous audit compared to the interim quarters, it is more difficult for managers to manipulate accruals upward at the end of the year, i.e. in the fourth quarter (Fan et al. 2010; Brown & Pinello 2007). Brown and Pinello (2007) provide evidence of increased expectations management in the fourth quarter, whereas Fan et al. (2010) provide evidence that classification shifting is more prevalent in the fourth quarter than in the interim quarters. To the extent that managers have already managed accruals upward in previous quarters, the ability to further manage accruals upward in the last quarter is constrained, therefore earnings management through income classification shifting may provide a better alternative or the only alternative (Fan et al. 2010). Prior literature also provides evidence that the frequency and magnitude of special items are significantly greater in the fourth quarter (Burgstahler, Jiambalvo & Shevlin 2002; Kinney & Trezevant 1997). Fan et al. (2010) make the conjecture that these results indicate that not only do managers have more incentives to employ classification shifting in the fourth quarter, but they also have greater opportunity to camouflage core expenses with other (true) special items. That is consistent with managers adopting alternative earnings management techniques in the fourth quarter (Cohen, Mashruwala & Zach 2009), and that it is more difficult to achieve earnings thresholds using accrual manipulation in the fourth quarter (Brown & Pinello 2007). Fan et al. (2010) also find that classification shifting is more prominent when managers appear to be constrained in their ability to manage current-period accruals because of prior upward accrual manipulation (Barton & Simko 2002). This is consistent with the reasoning that managers have a portfolio of choices

for manipulating reported performance and that when one option for manipulating earnings is limited, managers will turn to the next (Fan et al. 2010).

Although the fourth quarter is subject to a more rigorous audit compared to the interim quarters, this study does not support the assertion that during the fourth quarter accruals management would be conducted to a lesser extent. On the contrary, I find that accruals management and other types of earnings management behavior seem to be more prevalent in that quarter. Regarding classification shifting, during my empirical period the company reported extraordinary costs only once, in quarter one during the first year of my empirical period. However, that was announced beforehand and certain costs were transferred from quarter four to quarter one, as well as from quarter two to quarter one. In addition to shifting in time, I found classification shifting inside financial statements, i.e. classifying certain costs as extraordinary costs.

Generally, this study demonstrates that a company's potential for earnings management changes over time as its business operations develop, when it adopts new accounting methods or standards and when it changes or refines its accounting methods. The company constantly faces new situations and new critical issues (for example, the risk items in the balance sheet) that affect the potential for earnings management and these situations require substantial consideration from management. Thus, new potential for earnings management constantly emerges and the management has to decide how the issues are handled, for example goodwill issues, acquisitions and new accounting methods. In addition, the business and its profitability changes, even during short accounting periods and thus the relevant earnings management issues will change over time. Consequently, the amount of flexibility will also change and new possibilities for earnings management will arise and some possibilities will end, some of which make it possible to conduct income increasing or income decreasing earnings management. Thus the potential for earnings management is not static; on the contrary, it is dynamic. This highlights the importance of identifying the essential items that make it possible to conduct earnings management. It also highlights the importance to recognize the possible changes in a company's earnings management potential in order to focus on the relevant earnings management items. Otherwise there is a high risk of focusing on rather irrelevant items in measuring earnings management and making misleading conclusions about the occurrence of earnings management.

4.2.4 Conservatism and earnings management

The potential for earnings management depends on actors and actors may intentionally increase the potential that can be used with regard to discretion over

earnings. I demonstrate that such behavior may include adopting new accounting methods and refining existing accounting methods. In particular, the adoption of a very conservative accounting method, compared to the initial aggressive method, entailed a buffer that could be used to increase future earnings if necessary. In this case the buffer was explicitly the aim of the actor. This finding relates to the discussion in prior literature about whether conservatism facilitates earnings management. Critics of conservatism claim that it facilitates earnings management (see, for example: Penman 2001; Levitt 1998; FASB 1980; Devine 1963; AICPA 1939), however there is little evidence either supporting or refuting this claim (Jackson & Liu 2010). It is also worth remembering that, as already stated, the IFRS framework does not include conservatism; neutrality is mentioned as one component of reliability.

My findings are generally in line with Jackson and Liu (2010) who provide evidence of a strategic process whereby firms gradually build up reserves on the balance sheet and then release those reserves into earnings when needed. They explore only an individual accrual account on the balance sheet (the allowance for uncollectible accounts) and its counterpart on the income statement (bad debt expense). They state that firms having conservative allowances also have the greatest amount of accounting flexibility in the sense that they can more readily release into earnings previously recorded over-accruals of bad debt expense that have accumulated in the allowance account on the balance sheet.

This study therefore directly contributes to the discussion on whether conservative accounting facilitates earnings management and adds support to the suggestion made by Jackson and Liu (2010) that future research should more comprehensively analyze the relation between conservatism and earnings management. This study refines the issue and shed more light on the strategic process whereby firms build up reserves on the balance sheet and subsequently draw down those reserves to manage earnings. I demonstrate that this process may relate to many different accounts, thus providing evidence that many different items can be used in reserve building, for example bonus provisions, stage of completion methods and guarantee work provisions and R&D activation. The process may be very intentional and comprehensive, starting from the initial discussion of implementing a new accounting method in which the one intention is to adopt a method that makes it possible for managers to build reserves. Thus this building of reserves could be a wide-ranging phenomenon. I also demonstrate how the buffer is used i.e. the reserves are released. Such action includes and needs discretion and estimates from many managers as well as discussions with the business units i.e. discussing a projects' progress. However, my findings indicate that this is an actor-related issue and that there may be substantial differences between the opinions of the actors about the discretion possibility, i.e. flexibility and how it should or should not be used. Consequently, actors may adopt

similar conservative methods that build reserves. Nevertheless, there are differences as to how actively these reserves will be used (i.e. released) afterwards.

This study also indicates that conservative methods are used in order to avoid unpleasant surprises, which is in line with the observation by Hirshleifer and Teoh (2009) that managers prefer conservative accounting because it reduces the likelihood that they and others will be disappointed when the realization of significant accounting estimates become known in the future. Their insights suggest that managers may establish conservative allowances to protect against the possibility that future write-offs will exceed the allowance, because such events can push earnings below important thresholds (Brown & Caylor 2005; DeGeorge et al. 1999) and adversely affect managers' wealth (Matsunaga & Park 2001).

The findings contained herein support those of Jackson and Liu (2010), who state that conservatism may facilitate earnings management and may partially counterbalance some of its claimed benefits and those made by Graham et al. (2005) that many executives admit to drawing down reserves to meet an earnings target. On the practical level, I also agree with Jackson and Liu (2010) that an important implication of the result is that stricter limits on the amount by which firms are allowed to understate net assets may reduce the ability of firms to manage earnings.

4.3 Dynamics and the processes behind earnings management

This study demonstrates different processes behind earnings management and some of those have already been handled in the discussion. The prior literature has not paid almost any attention to these processes, except the study by Jorissen and Otley (2010), which *ex post* demonstrated certain processes which triggered the decision to engage in financial misrepresentation in a quite extreme earnings management case company.

This study provides evidence of a crucial process that could be interpreted as the legitimization of earnings management. This process relates to the fact that it is important to prepare and to be prepared to present official justifications of some accounting discretion to a company's auditor, and probably for other actors as well. The unofficial (the real reason) is often known inside the case company, even if there are different conceptions of the reason inside the company. Nevertheless, the official reason is presented to the auditor, but the auditor may sometimes realize the unofficial reason. This is the justification, or the legitimacy of the discretion. Thus the management, at least apparently, operates according to the pre-determined rules and according to the IFRS that sets the framework. It is important to justify the discretion to the auditor who will eventually legitimate it

and then the discretion is broadly considered to be in accordance with the IFRS. This suggests that management wants to cover its own back.

These justifications are important and the preparation of them is the key issue in the process. That preparation is sometimes a real art including all kind of estimations and views from the management and from the business units. They may include a dialogue between the financial management department and the business unit about the hour estimation of a project involved in a stage completion; they may consider the risk issues of a project that includes a provision for guarantee work; the estimation of some future performance that may have an effect on the bonus provision level; conceptions about issues related to an R&D project's justification to remain on the balance sheet or to be activated into the balance sheet in its first phase; views on how goodwill can be justified not written off; and so on. These considerations include a wide variety of issues that have to be justified, and these discussions are sometimes quite intense. Naturally the auditor and the IFRS are important framework setters, therefore the requirements of the IFRS are usually literally followed. The management learns to present the correct justifications to the auditor and usually it is hard for the auditor to object to the justifications because the management has an information advantage compared to the auditor. This information advantage was widely emphasized by all the actors in the company on many occasions. It was especially emphasized that the CFO decides whether or not something will be activated in the balance sheet or not. However, it was widely highlighted that such issues are almost always highly interpretative and that there is no unambiguous or objective truth, instead they are subjective and actor-dependent opinions.

In constructing the financial reports the above mentioned legitimation is very relevant as management has to find the correct justification for any discretion to be able to argue their choice to the auditor. Hence, the financial reports are released with a final result or construction that is the result of a negotiation process, and which will have been accepted by the auditor. The management must be able to defend how they made their decisions and present arguments to convince others of the choices made, and show that the reported result complies with IFRS rules and follows previously agreed practices.

In the case company, the previous CFO was very active in this process and directly admitted to using discretion in order to achieve certain targets and considered it natural that earnings are managed. However, the CEO, whose role appeared to be quite distant on accounting issues, always stated that all managerial discretions are made in accordance with IFRS and the pre-determined accounting principles and that earnings are not managed. Nevertheless, they both can state that the company was operating according to pre-determined rules and according to the IFRS.

I believe that earnings management emerges from the process in which justifications are generated and that there are some incentives for this behavior. There is a large difference in how active people are in this process and the key actor (in this case, the CFO) has a substantial role. As stated, the previous CFO was very active and initiated the preparing of these justifications, considering it a natural behavior. However, it appeared that the current CFO is not that active in preparing these justifications and, in fact demanded justifications from the business units regarding the R&D activation.

I demonstrate the legitimation process in different situations, and one version of that process manifested when profit appeared to be lower than expected. In that situation a different kind of checking of provisions and other discretionary items was conducted very actively and it was referred to as double-checking. An example of that kind of double-checking is the R&D expense activation in unit B during Q4 when they were actively searching for such items due to the low profitability. Such checking or double-checking would not have been conducted if the profit had been at the expected level. All actors admit the checking, however there are differences about the concepts regarding the incentives behind it and how purposeful it can be and what kind of discretion is allowed. The previous CFO actively sought these possibilities and contacted business units. He considered that a natural search for flexibilities and stated that they actively searched for discretion possibilities. However, others were not that outspoken and stated that they actively explored items that could probably be incorrect and they made sure that everything was correct. This can be argued as being a choice of words, but there were differences between the actors. In any case, the justifications, good and bad, were used in order to justify the certain discretion.

This study indicates that management may map new possibilities for earnings management and aspire to some margin to conduct earnings management. Therefore, new earnings management potential may be intentionally acquired by the management. This process can be highly active as shown by the example of the previous CFO's "back pocket". Furthermore, I present the process of adopting a new accounting method or refining an existing method. Such a process may start from a legitimate need to adopt some new method or to refine an existing method. The initiative may arise from business-related issues (e.g. new kind of projects or unsuccessful projects) or, especially, an auditor's request. In the case company, different alternative methods were discussed and presented regarding the implementation discussion. The implementation discussion was conducted amongst the management team, in which the role of the CFO was crucial, and took into account the accounting expertise needed for that discussion. Based on that discussion the appropriate accounting method was chosen and implemented, used and learned from. Nevertheless, later on, that method could be refined or changed. Generally, there is substantial discretion present in all of these phases

and if the key actor in the company is strongly earnings management oriented, he may prefer the methods that make it possible to use managerial discretion in the future by adopting a highly conservative method (i.e. constructing reserves) and then, if needed, using discretion to increase earnings by increasing income recognition (i.e. releasing reserves), amongst others.

4.4 The role of actors and their incentives in earnings management

I have already analyzed the role of different actors in earnings management and the importance of the actors' role has already arisen in this discussion. Next, I specifically discuss the key role of the CFO, compare the two CFOs and briefly consider the incentives for earnings management in the case company.

4.4.1 The key role of the CFO

Generally, senior management has a leadership role in generating and reporting earnings (see, for example: Desai, Hogan & Wilkins 2006). However, Ronen and Yaari (2008) find that although boards of directors have to approve key managerial decisions, the truth is that management makes operating, investment and financing decisions, like the design and execution of a business strategy, capital investment, and budgeting as well as the issuance of dividends and the acquisition of debt securities. In the process of making these decisions, management also acquires superior knowledge of the economics of the firm. My finding strongly supports the statement by Ronen and Yaari (2008) and indicates that the role of the board is trivial with regard to accounting issues, and although it can in principle draw some lines, in the end, neither the board nor the audit committee of the board of directors are able to question the operative discretionary choices made.

In comparison with the prior literature, this study highlights the importance of the CFO in relation to the CEO. The CFO focuses on accounting and economic related issues, thus a CFO has the best information and is probably the most competent person to deal with such issues. In this case it was indeed the CFO who "ran the game", in other words, is most deeply familiar with the balance sheet and who decides what is activated in it. Therefore, in the end, it appears that the CFO decides the company's perspective on accounting related issues and positions the company on the conservative-neutral-aggressive continuum in each situation. It appeared that inside this company there was no one with the competence to really challenge the CFO's opinion, not even the audit committee, and it appeared that the auditor was the only one who has the competence to discuss the

issues with the CFO. However, the CFO has an information advantage compared to the auditor. This could be a case-dependent issue, but I find that more attention should be paid to the CFO than has been done in prior literature. This is in line with Jiang et al. (2010) and Geiger and North (2006) whose findings suggest that the role of CFOs is crucial in earnings management, because the CFO's primary responsibility is financial reporting, and therefore the CFOs can significantly affect accounting quality. In fact, Geiger and North (2006) state that despite longstanding acknowledgement regarding the involvement of CFOs in the financial reporting process, little academic research has been conducted to examine the effect of the CFO on a company's reported financial result. The role of CFOs is apparent in Graham's et al. (2005) survey, since most of their respondents were CFOs, although Graham et al. do not specifically consider that.

As stated, the extant literature has focused primarily on how CEO's incentives affect earnings management, but this study suggests that more attention should be given to the CFO's incentives for earnings management. The evidence by Jiang et al. (2010) suggests that that CFO equity incentives play an independent role in companies' earnings management activities, even after controlling for CEO equity incentives, and that the role of the CFO equity incentives is greater than that of the CEO. Although I do not measure the effect of the different actors' incentives for earnings management, I agree with the Jiang et al. (2010) that the CFO's incentives could be the dominant incentives in earnings management. However, as Jiang et al. (2010) state, their findings may reflect the impact of other lower level executives in the organization, and therefore one should be cautious in attributing their findings about the relationship between CFO equity incentives and earnings management solely to the actions of the CFO. This study also revealed that wide-ranging discussions between the financial administration and the unit managers occur and it suggests that the incentives of unit managers could also have a role to play in earnings management behavior. Unit managers also have an information advantage compared to the CFO with regard to their business units.

4.4.2 Comparison of the two CFOs

In this study I had the unique possibility to compare the two CFOs and their conceptions of earnings management. To my knowledge, the differences between the CFO's conceptions of earnings management behavior in the same company have rarely been studied. Geiger and North (2006) investigate the association between the incoming CFO and earnings management and find that the incoming CFOs tend to be associated with a lower level of earnings management, in other words, they demonstrate a significant reduction in companies' reported discretionary

accruals.⁵⁹ They suggest that a change in a firm's CFO significantly affects the firm's reported result. Geiger and North state that their study extends earlier research by providing empirical evidence that individuals in CFO positions wield significant influence over the firm's reported financial result. My findings support Geiger and North (2006) in that the incoming CFO engaged less in what could be termed earnings management. However, more interestingly this study strongly supports their finding that the change of the CFO affects the firm's reported results, indicating the CFO's importance in earnings management.

As already stated this study indicates that discretionary behavior is highly CFO-related and that there are clear differences between the CFOs' activity in using managerial discretion and in using flexibilities i.e. using earnings management potential. Certainly, the attitude to the overall use of discretionary as well as to the CFO's back pocket was different. The current CFO found the concept very questionable and clearly found it manipulative. However, the previous CFO considered it an important tool for managing figures in the short run. He considered the active use of flexibilities and earnings management consideration a natural and normal practice.

I believe that this difference relates to the responses that Graham et al. (2005) got in their survey. Graham et al. state that several CFOs argue that, "you have to start with the premise that every company manages earnings". However, these executives are not talking about violating the GAAP or committing fraud. They are talking about "running the game", in a manner to produce smooth, attainable earnings from year to year (Graham et al. 2005). Thus, I find that the previous CFO was more active in "running the game" than the current CFO.

This study also demonstrates that one important reason for the previous CFO to adopt very conservative accounting methods in the first place was the fact that conservative methods create a buffer that can easily be used if needed. However, the current CFO finds that conservative accounting methods are used only for internal risk management purposes. There are also differences between the CFOs attitude to activation in the balance sheet. The previous CFO was more aggressive in balance sheet activation, for example, regarding the activation of an R&D expense, whereas the current CFO is clearly more carefully about the issue and insists on extensive calculus and justifications before anything can be activated.

Certain characteristics became evident when constructing the annual financial statement and it appeared that the previous CFO would have constructed it quite differently. He would have generated larger earnings lured by larger bonuses, but

⁵⁹ It is widely documented in the prior literature that new CEOs are more likely to reduce the reported result in their initial year, i.e. the so-called "big bath" (see, for example: Denis & Denis 1995; Murphy & Zimmerman 1993; Pourciau 1993; DeAngelo 1988b; Strong & Meyer 1987).

also larger dividends would have been paid in his plan.⁶⁰ Naturally larger earnings would have required larger balance sheet activations. Thus it generally appears that the picture of the company would have been quite different if the previous CFO would have constructed the annual financial statement. It is worth emphasizing that the prior CFO considered personal bonuses very important, which affected his attitude to constructing the annual financial statement. There were clear differences between the CFOs in how they considered the incentive schemes and that affected earnings management behavior.

In addition, there is a clear difference in the CFOs' attitude to disclosure politics. The previous CFO finds that disclosure politics, especially numerical public guidance is very important for increasing investor confidence in the company in the markets. He also argues that smoother and more predictable earnings, especially in quarters, are important and he also uses discretion over earnings more actively in order to meet targets. Therefore, the previous CFO can be said to have been strongly oriented to the stock market and to have operated quite aggressively. In contrast, the current CFO is more business-oriented and operates quite conservatively. In fact, a difference in the outlook between the CFO's was perceived inside the company. However, the current CFO used very substantial discretion in considering avoiding the goodwill impairment loss recognition, firstly by considering the corrective actions, secondly, by avoiding impairment during the financial crisis.

I find that only a part of the difference is explained by the incoming CFO argument presented by Geiger and Norton (2006). Instead, I conclude that there are other differences between the CFOs that affect their earnings management behavior, such as how aggressively they try to achieve their personal bonuses. More broadly these findings indicate, in line with Hines (1988; 1991), that the picture of a firm is actor-related, in this case CFO-dependent. Furthermore, I agree with Jorissen & Otley (2010) that the definitions of earnings management point to the central role of top management in these decisions. However, accounting literature has not taken into account heterogeneity among top managers and its possible impact on earnings management (Jorissen & Otley 2010). They emphasize the central role of the CEO and provide evidence that a deeper knowledge of the characteristics of the CEO and of the factors that determine the distribution of power among corporate managers is required to advance knowledge of financial misrepresentation or earnings management. As the key actor in my case appears to be the CFO, I more generally agree with Jorissen and Otley (2010) and conclude that a deeper knowledge of the characteristics of the

⁶⁰ The financial manager, as acting CFO, mainly constructed the annual financial statement after the previous CFO had left. The financial manager did not receive management bonuses.

key actor is required in order to better understand earnings management behavior.

4.4.3 Incentives for earnings management

The discussion has already considered certain incentives for earnings management in the case company and broadly the incentives are in line with the prior research. This study demonstrates that there are various incentives inside the company and that the incentives have a substantial effect on earnings management behavior. In constructing the annual financial statement the dominating incentive for earnings management related to bonuses. However, it seemed that there were differences between the CFOs in how actively they use accounting discretion in order to receive bonuses. The previous CFO actively tried to use discretion in order to receive bonuses, whereas the current CFO seems to be much moderate.

During the accounting period it was important to meet the public guidance in the interim reports, especially for the previous CFO. Also the current CFO stated that checking for possibilities to use accounting discretion is conducted if the result is below public guidance. During the accounting period the previous CFO also found it important to generate smooth earnings in order to be considered a lower risk and more predictable company. However, that was only emphasized by the previous CFO. It seemed that the previous CFO took it personally if public investor guidance was not reached. It appears that personal reputation, or some kind of compulsion to show that everything is under control affected his discretionary behavior. However, the current CFO is apparently more moderate. Thus it was quite natural that the previous CFO was eager to adopt numerical public guidance because he was ready to use “flexibilities” in order to meet the public guidance targets. By conducting income smoothing, and thus meeting the earnings estimates on the interim and on the annual level, it could seem to outsiders that the company is a lower risk investment compared to a situation where earnings estimates are not met or not even published. This again highlights the importance of the CFO but also reveals that the picture of a company that is given to the markets depends on the actors who are in charge of financial management.

To sum up this chapter I conclude that it presents many findings related to earnings management. Some of the findings support the prior literature and some provide additional insights or refine prior findings. However, some findings contradict previous results and some findings provide new insights on earnings management that have not been discussed in prior literature. In next chapter (i.e. the chapter 5) I present the conclusions and an evaluation of the study.

5 CONCLUSIONS AND EVALUATION OF THE STUDY

5.1 Conclusions

This is the first study that pays serious attention to earnings management behavior in the actual process of preparing corporate financial reports and analyzes earnings management *ex ante*, during its making as well as *ex post*. This study increases our understanding of earnings management by shedding light on earnings management behavior in the process of preparing corporate financial reports, i.e. focusing on the context in which earnings management takes place.

Broadly, this study demonstrates different kind of behavior related to earnings management, numerous different methods for earnings management, different kinds of processes relating to earnings management, various potential for earnings management and also different incentives for earnings management. In general, the discussion demonstrates that the findings are to some extent in line with prior conventional earnings management literature. In addition, they are in line with the methodology which allowed certain prior conceptions of earnings management to be refined and "tested". However, I mainly classify my study as theory discovery-oriented and state that this especially relates to opening the black box of earnings management, which is an action that is very explorative in nature. Therefore, the general contribution of this study is to open the black box of earnings management. More specifically, the contribution is threefold.

First, this study contributes to our understanding of the concept of earnings management i.e. what earnings management is. Previous earnings management literature has commonly adopted a concept according to which the difference between managed and unmanaged earnings is unambiguously dichotomous. That is quite an understandable assumption taking into account the positivistic nature of mainstream earnings management research. In contrast, this study takes a more subjectivistic point of view and reveals the conceptual and situation dependent negotiations between the actors and the highly interpretative nature of the use of accounting discretion. This study indicates that the premise of earnings without management is not a clear cut concept.

Thus the main contribution of this study is that the concept of earnings management is not as unambiguous as the prior literature has assumed. Earnings management is deeply intertwined with the process of preparing corporate financial reports and in that process there is large diversity of earnings management

related behavior and an extensive variety of earnings management potential. This study reveals that the picture that is given to the capital markets as well as the so-called true picture of the company is the result of much interpretation and negotiation and is actor dependent. Therefore, the dichotomy between managed earnings and unmanaged earnings is far from obvious. Earnings management is socially constructed, interpretative, depends on the concepts held by actors and it is not an absolutely dichotomous concept. Thus earnings management is an outcome of negotiations between different actors, and these negotiations and discussions include a large variety of issues to which different processes are related, including the legitimation of the accounting discretion. This finding suggests socially constructed and interpretative earnings management is the norm and challenges the prevailing uniformity of prior earnings management literature about "true" or "neutral" earnings, i.e. the concept of managed vs. unmanaged earnings.

In general, this finding has relevant implications as every earnings management study has to adopt some definition of earnings management and thereby commit itself to the matter of how to measure earnings management. This finding also suggests that only extreme earnings management, if even that, can be reliably recognized and modeled directly from financial statements. Therefore, there is a high risk for misleading and limited conclusions about earnings management if an analysis is only based on public financial statements.

Second, this study contributes to the knowledge about the role of individuals in earnings management and their importance in conducting it. Prior literature has mainly emphasized the importance of context in earnings management behavior, whereas the role and the importance of the actors have remained, to some degree, unclear. This study also emphasizes the role and the importance of actors in conducting earnings management and indicates that earnings management is much more actor-related than prior literature has assumed.

This study highlights the fact that the key actor in conducting earnings management is the CFO. The CFO is in charge of the discretionary accounting decisions, has control over the profit and loss account and the balance sheet and ultimately decides the company's perspective on managerial discretion and also provides arguments for the accounting discretion and justifies it to the CEO. I argue that the CFO has an information advantage with respect to the financial statements compared to the CEO when discussing the use of accounting discretion. Therefore, there is a case for saying that the CFO is the key actor in conducting earnings management. This finding contradicts the common assumption of the prior literature about the CEO's key role in conducting earnings management. My findings suggest that focusing only on the CEO in earnings management will lead to misleading conclusions and that more attention should be given to the CFO. In fact, the CFO's attitude on earnings management should never be neglected and more attention should also be paid to the interplay between different

actors and the way they influence each other, especially between the CFO and the CEO.

Furthermore, this study highlights the high information asymmetry between different actors in the negotiation of accounting discretion. A key actor in earnings management could rather strategically and systematically use his information advantage and his expertise in accounting discretion related discussions and in constructing the result. In addition, the comparison of the two CFOs indicates highly different behavior and attitudes to earnings management. In particular, their attitude to various incentives, both implicit and explicit, is highly different and has influenced earnings management behavior. This comparison strengthens the conclusion that earnings management is actor-dependent. All this suggests that it is important to identify the key actor or actors of earnings management. This study also indicates that to some extent the actor, rather than a certain context, could be more broadly considered as the explanatory factor in earnings management behavior. Therefore, studies should pay more attention, not only to actors' incentives, but also to actors' personal characteristics and history in order to better explain earnings management behavior.

Third, this study contributes to knowledge about the processes and potential for earnings management by revealing possible practices that had not been previously recognized in academic research. Generally, this study demonstrates different and new types of processes behind earnings management and shows that there are different situations that generate a variety of possibilities and new possibilities for earnings management. Relevant earnings management issues and earnings management potential vary over time reducing the possibility to reliably recognize earnings management from the financial statements with the aid of a mechanical model. For example, this study demonstrates new situations, new kinds of discretionary behavior, processes and earnings management potential that relate to goodwill impairment testing and acquisition related issues. Although these issues are familiar and usually significance, they have rarely been analyzed in-depth in prior earnings management literature and are currently only very vaguely reported in financial statements in the IFRS world, thus increasing the potential for earnings management. This finding has clear legislative and enforcement implications suggesting that more research and disclosure is required on these issues, in order better to serve investors and other interest groups.

Generally, it appears that balance sheet management as well as disclosure management played an important role. To some extent balance sheet management can be seen as a primary object, although it naturally has an effect on earnings. Taking into account also the large intensity of disclosure management demonstrated in the case, my suggestion is that earnings management should be seen in broader terms than literally just *earnings* management. Furthermore, increased uncertainty in a rapidly changing world has partly led to unrepeated

changes in disclosure politics and segment reporting. In the case company, that meant changes in the picture of the company on a year to year basis and made it very difficult for outsiders to analyze it, especially with regard to comparing years and quarters. Such inability to accurately compare accounting periods has also increased earnings management potential. In addition, the huge amount of interpretation that IFRS allows and requires from management, as well as the fact that IFRS practices are not yet well established, offers huge potential for earnings management.

The opening of the black box of earnings management has proved that earnings management is a very complex phenomenon that includes many dimensions. I conclude that most earnings management behavior will not be perceived if analyses are only based on completed financial statements. In addition, it seems that a large proportion of earnings management is not captured by quantitative models and therefore there is a high risk of random and misleading conclusions regarding earnings management. Thus several fruitful possibilities for gaining additional insights into earnings management are available.

5.2 Evaluation of the study and future research opportunities

Generally, this research attempted to open the black box of earnings management. To my knowledge, this is the first study that analyzed earnings management *ex ante*, during its making as well as *ex post*. I have attempted to comprehensively analyze earnings management and thus the scope of this study is quite broad. Although I have analyzed a highly complex phenomenon, I have kept the analysis level rather straightforward in order to be able to focus on the main purpose of this study. I have not tried to create a list of all possible factors potentially having an effect on earnings management, because would not have been relevant for this study. The focus of the study has been to open the black box of earnings management and I find that I have succeeded in that.

As we recall, the contribution of the study is threefold, including: the interpretative nature of the concept of earnings management; the knowledge of the actors and their role in conducting earnings management; the processes and potential for earnings management. In addition, there are many more detailed findings presented, some of which support the prior literature whereas some do not. Although many findings of this study are in line with the prior literature, there are several findings that clearly add to our knowledge of earnings management. All this suggests that the exploration of this study is successful. However, this study leaves certain issues open and offers several building blocks for future study.

This thesis naturally has some potential limitations. It is always relevant to evaluate the reliability and quality of the empirical data. This is especially im-

portant in evaluating this study, since it relies strongly on the observations made in the target company. Therefore, it is natural to evaluate the data gathered from the case in a critical way.

In general, the subject of this study is sensitive, therefore it is possible that some of the interviewees do not tell the truth, or understate their personal incentives for earnings management. As demonstrated in the empirical section there were some contradicting views on issues related to why some discretion is conducted, what kind of managerial discretion is used in certain situations, or how important certain thresholds are. Some actors admit that discretion is used in order to meet earnings thresholds and they admit that the incentives may have an effect on discretionary behavior. However, some actors deny that incentives have any effect on discretionary behavior. These differences can be partly explained by the differences in peoples' characteristics, what had actually occurred and why it occurred, and how directly they explain the courses of action and decisions taken. These differences may relate to different responsibilities regarding the issues and thus some actors may not want to admit to anything. It also appears that some actors are not familiar with the huge flexibilities that the IFRS allow, and thus they may see quite limited earnings management potential. In addition, their role in constructing the financial reports may be rather distant, and thus they were not familiar with the discussions that were conducted during the process of preparing a financial statement. Generally, actors possess different information based on where and how they operate and what they make their decisions on, thus ensuring that information asymmetry between actors is prevalent and therefore a relevant issue. In general, the IFRS is still quite a new set of international accounting rules and it offers a huge amount of discretionary issues, and therefore many actors know it only cursorily. Thus their views might be flawed because, as demonstrated, the company consistently faces new business-related issues or situations that require new interpretations of the IFRS, and these new issues are only discovered when they arise.

By considering the above mentioned considerations, the quality of the data that was gathered through interviews was consistent, which contributes reliability to the study. The data collection intensity and the amount of interviews could have been higher. This could have provided additional elements, especially regarding the analysis of earnings management "during" its creation. It could have brought out some additional insights and more detailed stories. However, I believe that it would likely not have influenced the main conclusions due to the fact that I had several interviews with the CFOs and with the financial manager and their findings were, in general terms, strongly in line with each other, thus indicating that the findings are reliable. I also find that I reached saturation during my field work. In addition, the empirical period of the study was rather long and it was possible to verify and ask for more specifics on the initial findings and

concepts. Thus I had several opportunities to discuss the issues at hand and then further elaborate on them and specify the findings and reflect on them regarding the different actors' views. During the research process certain initial notions were confirmed, while many others were modified or rejected. Certain issues were verified afterwards with the company. In addition, the key issues of the study were discussed and validated during the interviews with APAs who do not audit the case company. Additionally, triangulation has improved the validity of the research in general.

I consider my results to have high validity and to be relevant to the issue of earnings management. I adopted a broad definition of earnings management and followed that definition consistently throughout the study. The purpose was to analyze earnings management in the process of preparing corporate financial reports. Therefore, for example, accrual accounting issues are discussed and considered in the empirical part because earnings management occurs and is intertwined with accrual accounting issues in different forms. In addition, the findings of this study, to some extent, support prior earnings management literature. However, they also provide certain additional relevant insights, especially regarding the previously unambiguous concept of earnings management.

When evaluating the generalizability of the results, the inherent limitations of the single case study to provide (at least statistical) generalizations are acknowledged. Therefore, case studies usually attempt to counterbalance the impossibility of applying statistical inferences by pointing out the large theoretical or practical relevance of the research subject, the thoroughness of analysis and interpretation, and the triangulation of research methods (see: Lukka & Kasanen 1995; Spicer 1992; Scapens 1990; Silverman 1985; Yin 1984). For example, while considering the role of case study research in accounting research, Scapens (1990) points out that instead of making statistical generalizations, we should look at theoretical generalizations that aim to generalize theories so that they explain the observations made.

Lukka and Kasanen (1995) approach the question of generalizability in accounting research by adopting a broad perspective and argue that generalization to a reasonable extent is possible from a properly conducted case study. They list the following elements that form the preconditions for generalizability in any properly conducted accounting study: 1) theoretical knowledge of the subject area, 2) prior empirical studies and their interpretations, 3) the empirical results and their interpretations based on the study in question. Only if all these issues have been thoroughly analyzed, and then synthesized into a convincing story, will the reader even consider what the scope of the results could be (Lukka & Kasanen 1995). Finally, Lukka and Kasanen state that in order to be able to make generalizations they need the argument, made by Martin et al. (1983), that companies are fundamentally quite similar, at least in similar conditions. Thereafter

Lukka and Kasanen (1995) introduce three different types of generalization rhetoric: statistical, contextual, and constructive. With regard to this study the contextual rhetoric is the most relevant. Contextual generalization rhetoric provides a way to move from the isolated observations to results of a more general status. According to contextual generalization rhetoric, a successful case study may provide the possibility to widen the validity of the research results beyond the primary observations by the efficient triangulation of the data elements. A necessary condition for the power of contextual generalization rhetoric is the attainment of a thorough understanding in the main case analysis and its credible reporting. Lukka & Kasanen point out that to make such a rhetoric work, the researcher has to understand and communicate the real business context and uncover the general structural relationship. Therefore the key point is a meaningful and convincing connection of the study with the real-world phenomena surrounding the case in question, such as history, institutions and markets. Thus Lukka and Kasanen (1995) argue that substantial knowledge from the real world plays a key role when attempting to gain both generalizable and substantially relevant results.

I have communicated the real business context and all the results have a meaningful and convincing connection with real-world phenomena. The contribution of this study derives from practical issues that could be considered relevant in almost every listed company. For example the discretionary accounting issues and their highly interpretative nature are issues that are common to almost all companies that follow the IFRS. That interpretative nature was widely demonstrated on various occasions and in relation to many accounting issues. Thus, according to the contextual rhetoric, it seems that it is highly possible that the results could be generalized to a wider context, although they derive from this single study. In addition, although certain detailed findings are, to some extent, IFRS specific, many findings could be considered more abstract and to have broader implications.

Broadly, Lukka and Kasanen (1995) state that one of the most important characteristics of a successful case study is that it can convince the reader of the validity of the case description and analysis, i.e. it makes a credible impression. Furthermore, credibility and common interest have to be shown by linking the research problem and results with relevant issues from the accounting viewpoint, and by showing that the results are, in one way or another, meaningful either in developing accounting theory or practice (Lukka & Kasanen 1995). In line with these arguments I find that the research problem and results in this study are linked with relevant issues from the accounting viewpoint, and that the results are meaningful in developing our understanding of earnings management in terms of both theory and practice. Having presented this point of view, the value of the study remains to be decided by the reader.

The issues studied and the limitations presented offer several further research possibilities. I encourage scholars to conduct case study analyses that would include more observation inside firms and more interviews. This could also include assessing a specific issue presented in this study and combining management accounting theories with earnings management studies. Comparative case analyses could be also fruitful. In addition, I find that my criticism of quantitative models can be seen as a challenge to create more sophisticated models that could better take into account some of the insights of this study. In the future, new models should be better at taking into account, for example, the roles of key personnel in the preparing of financial statements.

REFERENCES

- Abarbanell, J. S. – Bushee, B. J. (1997) Fundamental analysis, future earnings, and stock prices. *Journal of Accounting Research*, Vol. 35 (1), 1–24.
- Adiel, R. (1996) Reinsurance and the management of regulatory ratios and taxes in the property-casualty insurance industry. *Journal of Accounting and Economics*, Vol. 22 (1–3), 207–240.
- Ahmed, A. S. – Guler, L. (2007) *Evidence on the effects of SFAS 142 on the reliability of goodwill write-offs*. Working paper, Texas A & M University.
- Ahrens, T. – Chapman, C. S. (2006) Doing qualitative field research in management accounting: positioning data to contribute to theory. *Accounting, Organizations and Society*, Vol. 31 (8), 819–841.
- Akerlof, G. A. (1970) The market for "lemons": quality uncertainty and the market mechanism. *The quarterly Journal of Economics*, Vol. 84 (3), 488–500.
- Alciatore, M. – Dee, C. C. – Easton, P. – Spear, N. (1998) Asset write-downs: a decade of research. *Journal of Accounting Literature*, Vol. 17 (1), 1–39.
- American institute of certified public accountants (AICPA), Committee on accounting procedures. Unamortized discount and redemption premium on bonds refunded. *Accounting Research Bulletin, No 2*. New York: AICPA, 1939.
- Armstrong, C. S. – Jagolinzer, A. D. – Larcker, D. F. (2010) Chief executive officer equity incentives and accounting irregularities. *Journal of Accounting Research*, Vol. 48 (2), 225–271.
- Arnold, B. – Lange, P., de (2004) Enron: an examination of agency problems. *Critical Perspectives on Accounting*, Vol. 15 (6–7), 751–765.
- Arrow, K. J. (1973) Higher education as a filter. *Journal of Public Economics*, Vol. 2 (3), 193–216.
- Ayres, F. L. (1994) Perceptions of earnings quality: what managers need to know. *Management Accounting*, Vol. 75 (9), 27–29.
- Baber, W. R. – Fairfield, P. M. – Haggard, J. A. (1991) The effect of concern about reported income on discretionary spending decisions: the case of research and development. *The Accounting Review*, Vol. 66 (4), 818–829.
- Baker, R. – Hayes, R. (2004) Reflecting from over substance: the case of Enron Corporation. *Critical Perspectives on Accounting*, Vol. 15 (6–7), 767–785.
- Ball, R. (2006) International financial reporting standards (IFRS): pros and cons for investors. *Accounting and Business Research*, Vol. 36 (Special issue), 5–27.

- Ball, R. – Shivakumar, L. (2005) Earnings quality in UK private firms: comparative loss recognition timeliness. *Journal of Accounting and Economics*, Vol. 39 (1), 83–128.
- Barnea, A. – Ronen, J. – Sadan, S. (1976) Classificatory smoothing of income with extraordinary items. *The Accounting Review*, Vol. 51 (1), 110–122.
- Barth, M. E. (2006) Including estimates of the future in today's financial statements. *Accounting Horizons*, Vol. 20 (3), 271–285.
- Barth, M. E. – Cram, D. P. – Nelson, K. K. (2001) Accruals and the prediction of future cash flows. *The Accounting Review*, Vol. 76 (1), 27–58.
- Barth, M. E. – Elliott, J. A. – Finn, M. W. (1999) Market rewards associated with patterns of increasing earnings. *Journal of Accounting Research*, Vol. 37 (2), 387–413.
- Barton, J. – Mercer, M. (2005) To blame or not to blame: analysts' reactions to external explanations for poor financial performance. *Journal of Accounting and Economic*, Vol. 39 (3), 509–533.
- Barton, J. – Simko, P. J. (2002) The balance sheet as an earnings management constraint. *The Accounting Review*, Vol. 77 (4), 1–27.
- Bartov, E. (1993) The timing of asset sales and earnings manipulation. *The Accounting Review*, Vol. 68 (4), 840–855.
- Bartov, E. – Givoly, D. – Hayn, C. (2002) The rewards to meeting or beating earnings expectations. *Journal of Accounting and Economic*, Vol. 33 (2), 173–204.
- Bartov, E. – Gul, F. A. – Tsui, J. S. L. (2000) Discretionary-accruals models and audit qualifications. *Journal of Accounting and Economics*, Vol. 30 (3), 421–452.
- Bartov, E. – Lindahl, F. W. – Ricks, W. E. (1998) Stock price behaviour around announcement of write-offs. *Review of Accounting Studies*, Vol. 3 (4), 327–346.
- Beatty, A. – Chamberlain, S. – Magiolo, J. (1995) Managing financial reports of commercial banks: the influence of taxes, regulatory capital, and earnings. *Journal of Accounting Research*, Vol. 33 (2), 231–261.
- Beatty, A. – Weber, J. P. (2003) The effects of debt contracting on voluntary accounting method changes. *The Accounting Review*, Vol. 78 (1), 119–142.
- Beaver, W. H. – Engel, E. E. (1996) Discretionary behaviour with respect to allowances for loan losses and the behaviour of security prices. *Journal of Accounting and Economics*, Vol. 22 (1–3), 177–206.
- Beaver, W. H. – Kennelly, J. W. – Voss, W. M. (1968) Predictive ability as a criterion for the evaluation of accounting data. *The Accounting Review*, Vol. 43 (4), 675–683.
- Beaver, W. H. – McNichols, M. F. (1998) The characteristics and valuation of loss reserves of property casualty insurers. *Review of Accounting Studies*, Vol. 3 (1–2), 73–95.
- Beaver, W. H. – McNichols, M. F. – Nelson, K. (2007) An alternative interpretation of the discontinuity in earnings distribution. *Review of Accounting Studies*, Vol. 12 (4), 525–556.

- Beneish, M. D. (1997) Detecting GAAP violation: implications for assessing earnings management among firms with extreme financial performance. *Journal of Accounting and Public Policy*, Vol. 16 (3), 271–309.
- Beneish, M. D. (1998) A call for papers: earnings management. *Journal of Accounting and Public Policy*, Vol. 17 (1), 85–88.
- Beneish, M. D. (2001) Earnings management: a perspective. *Managerial Finance*, Vol. 27 (12), 3–17.
- Beneish, M. D. – Vargus, M. E. (2002) Insider trading, earnings quality, and accrual mispricing. *The Accounting Review*, Vol. 77 (4), 755–791.
- Bens, D. A. – Nagar, V. – Wong, M. H. F. (2002) Real investment implications of employee stock option exercises. *Journal of Accounting Research*, Vol. 40 (2), 359–393.
- Benston, G. J. – Hartgraves A. L. (2002) Enron: what happened and what we can learn from it. *Journal of Accounting and Public Policy*, Vol. 21 (2), 105–127.
- Berger, P. G. (1993) Explicit and implicit tax effects of the R&D tax credit. *Journal of Accounting Research*, Vol. 31 (2), 131–171.
- Berger, P. L. – Luckmann, T. (1966) *The social construction of reality: a treatise in the sociology of knowledge*. Doubleday & Co, New York.
- Bergstresser, D. – Philippon, T. (2006) CEO incentives and earnings management. *Journal of Financial Economics*, Vol. 80 (3), 511–529.
- Bernard, V. L. (1995) The Feltham-Ohlson framework: implications for empiricists. *Contemporary Accounting Research*, Vol. 11 (2), 733–747.
- Bernard, V. L. – Skinner, D. J. (1996) What motivates managers' choice of discretionary accruals? *Journal of Accounting and Economics*, Vol. 22 (1–3), 313–325.
- Bhattacharya, N. – Black, E. L. – Christensen, T. E. – Mergenthaler, R. D. (2004) Empirical evidence on recent trends in pro forma reporting. *Accounting Horizons*, Vol. 18 (1), 27–43.
- Bloomfield, R. J. – Luft, J. L. (2006) Responsibility for cost management hinders learning to avoid the winner's curse. *The Accounting Review*, Vol. 81 (1), 29–47.
- Botosan, C. A. – Stanford, M. (2005) Managers' motives to withhold segment disclosures and the effect of SFAS No. 131 on analysts' information environment. *The Accounting Review*, Vol. 80 (3), 751–771.
- Bowen, R. M. – Davis, A. K. – Rajgopal, S. (2002) Determinants of revenue-reporting practices for Internet firms. *Contemporary Accounting Research*, Vol. 19 (4), 523–562.
- Bowen, R. M. – DuCharme, L. – Shores, D. J. (1995) Stakeholders' implicit claims and accounting method choice. *Journal of Accounting and Economics*, Vol. 20 (3), 255–295.
- Bradshaw, M. T. – Sloan, R. G. (2002) GAAP versus the street: an empirical assessment of two alternative definitions of earnings. *Journal of Accounting Research*, Vol. 40 (1), 41–66.

- Brown, L. D. – Caylor, M. L. (2005) A temporal analysis of quarterly earnings thresholds: propensities and valuation consequences. *The Accounting Review*, Vol. 80 (2), 423–440.
- Brown, L. D. – Pinello, A. S. (2007) To what extent does the financial reporting process curb earnings surprise games? *Journal of Accounting Research*, Vol. 45 (5), 947–981.
- Bruns, W. J. – Merchant, K. A. (1990) The dangerous morality of managing earnings. *Management Accounting*, Vol. 72 (2), 22–25.
- Bunsis, H. (1997) A description and market analysis of write-off announcements. *Journal of Business Finance & Accounting*, Vol. 24 (9–10), 1385–1400.
- Burgstahler, D. – Dichev, I. (1997) Earnings management to avoid earnings decreases and losses. *Journal of Accounting and Economics*, Vol. 24 (1), 99–126.
- Burgstahler, D. – Jiambalvo, J. – Shevlin, T. (2002) Do stock prices fully reflect the implications of special items for future earnings? *Journal of Accounting Research*, Vol. 40 (3), 585–612.
- Burrell, G. – Morgan, G. (1979) *Sociological paradigms and organizational analysis. Elements of the sociology of corporate life*. Gower, Guilford.
- Bushee, B. J. (1998) The influence of institutional investors on myopic R&D investment behavior. *The Accounting Review*, Vol. 73 (3), 305–333.
- Butler, M. – Leone, A. J. – Willenborg, M. (2004) An empirical analysis of auditor reporting and its association with abnormal accruals. *Journal of Accounting and Economics*, Vol. 37 (2), 139–165.
- Cahan, S. F. (1992) The effect of antitrust investigations on discretionary accruals: a refined test for political-cost hypothesis. *The Accounting Review*, Vol. 67 (1), 77–95.
- Callao, S. – Jarne, J. I. (2010) Have IFRS affected earnings management in the European Union? *Accounting in Europe*, Vol. 7 (2), 159–189.
- Caylor, M. L. (2010) Strategic revenue recognition to achieve earnings benchmarks. *Journal of Accounting and Public Policy*, Vol. 29 (1), 82–95.
- Cazavan-Jeny, A. – Jeanjean, T. (2006) The negative impact of R&D capitalization: a value relevance approach. *European Accounting Review*, Vol. 15 (1), 37–61.
- Cheng, A. C. S. – Liu, C. S. – Schaefer, T. F. (1996) Earnings permanence and the incremental information content of cash flows from operations. *Journal of Accounting Research*, Vol. 34 (1), 173–181.
- Cheng, Q. – Warfield, T. D. (2005) Equity incentives and earnings management. *The Accounting Review*, Vol. 80 (2), 441–476.
- Cheng, S. (2004) R&D expenditures and CEO compensation. *The Accounting Review*, Vol. 79 (2), 305–327.
- Cohen, D. A. – Dey, A. – Lys, T. (2008) Real and accrual-based earnings management in the pre- and post-Sarbanes-Oxley periods. *The Accounting Review*, Vol. 83 (3), 757–787.

- Cohen, D. A. – Mashruwala, R. – Zach, T. (2009) *The use of advertising activities to meet earnings benchmarks: evidence from monthly data*. Working paper, New York University.
- Cohen, D. A. – Zarowin, P. (2010) Accrual-based and real earnings management activities around seasoned equity offering. *Journal of Accounting and Economics*, Vol. 50 (1), 2–19.
- Collins, D. W. – Hribar, P. (2000) Earnings-based and accrual-based market anomalies: one effect or two? *Journal of Accounting and Economics*, Vol. 29 (1), 101–123.
- Cooper, J. C. – Selto, F. H. (1991) An experimental examination of the effects of SFAS No. 2 on R&D investment decisions. *Accounting, Organizations and Society*, Vol. 16 (3), 227–242.
- Das, S. – Zhang, H. (2003) Rounding-up in reported EPS, behavioural thresholds, and earnings management. *Journal of Accounting and Economics*, Vol. 35 (1), 31–50.
- Davidson, S. – Stickney, C. P. – Weil, R. L. (1988) *Financial accounting: an introduction to concepts, methods and uses*. Fifth ed. Dryden Press, Chicago.
- Davis, A. K. (2002) The value relevance of revenue for internet firms: does reporting grossed-up or barter revenue make a difference? *Journal of Accounting Research*, Vol. 40 (2), 445–477.
- DeAngelo, H. – DeAngelo, L. E. – Skinner, D. J. (1994) Accounting choices in troubled companies, *Journal of Accounting and Economics*, Vol. 17 (1–2), 113–143.
- DeAngelo, L. E. (1986) Accounting numbers as market valuation substitutes: a study of management buyouts of public stockholders. *The Accounting Review*, Vol. 61 (3), 400–420.
- DeAngelo, L. E. (1988a) Discussion of evidence of earnings management from the provision for bad debts. *Journal of Accounting Research*, Vol. 26 (3), 32–40.
- DeAngelo, L. E. (1988b) Managerial competition, information costs, and corporate governance: the use of accounting performance measures in proxy contests. *Journal of Accounting and Economics*, Vol. 10 (1) 3–36.
- Dechow, P. M. (1994) Accounting earnings and cash flows as measures of firm performance: the role of accounting accruals. *Journal of Accounting and Economics*, Vol. 18 (1), 3–42.
- Dechow, P. M. – Dichev, I. D. (2002) The quality of accruals and earnings: the role of accrual estimation errors. *The Accounting Review*, Vol. 77 (4), 35–59.
- Dechow, P. M. – Richardson, S. A. – Tuna, I. A. (2003) Why are earnings kinky? An examination of the earnings management explanation. *Review of Accounting Studies*, Vol. 8 (2–3), 355–384.
- Dechow, P. M. – Skinner, D. J. (2000) Earnings management: reconciling the views of accounting academics, practitioners, and regulators. *Accounting Horizons*, Vol. 14 (2), 235–250.

- Dechow, P. M. – Sloan, R. G. (1991) Executive incentives and the horizon problem: an empirical investigation. *Journal of Accounting and Economics*, Vol. 14 (1), 51–89.
- Dechow, P. M. – Sloan, R. G. – Sweeney, A. P. (1995) Detecting earnings management. *The Accounting Review*, Vol. 70 (2), 193–225.
- DeFond, M. L. – Jiambalvo, J. (1994) Debt covenant violation and manipulation of accruals. *Journal of Accounting and Economics*, Vol. 17 (1–2), 145–176.
- DeFond, M. L. – Park, C. W. (2001) The reversal of abnormal accruals and the market valuation of earnings surprises. *The Accounting Review*, Vol. 76 (3), 375–404.
- DeGeorge, F. – Patel, J. – Zeckhauser, R. (1999) Earnings management to exceed thresholds. *Journal of Business*, Vol. 72 (1), 1–33.
- Denis, D. J. – Denis, D. K. (1995) Performance changes following top management dismissals. *Journal of Finance*, Vol. 50 (4), 1029–1057.
- Desai, H. – Hogan, C. E. – Wilkins, M. S. (2006) The reputational penalty for aggressive accounting: earnings restatements and manager turnover. *The Accounting Review*, Vol. 81 (1), 83–112.
- Devine, C. T. (1963) The rule of conservatism re-examined. *Journal of Accounting Research*, Vol. 1 (2), 127–138.
- Dichev, I. D. – Skinner, D. J. (2002) Large-sample evidence on the debt covenants hypothesis. *Journal of Accounting Research*, Vol. 40 (4), 1091–1123.
- Dowdell, T. D. – Press, E. (2004) The impact of SEC scrutiny on financial statement reporting of in-process research and development expense. *Journal of Accounting and Public Policy*, Vol. 23 (3), 227–244.
- Duncan, J. R. (2001) Twenty pressures to manage earnings. *CPA Journal*, Vol. 71 (7), 32–37.
- Durtschi, C. – Easton, P. (2005) Earnings management? The shapes of the frequency distributions of earnings metrics are not evidence ipso facto. *Journal of Accounting Research*, Vol. 43 (4), 557–592.
- Durtschi, C. – Easton, P. (2009) Earnings management? Erroneous interferences based on earnings frequency distributions. *Journal of Accounting Research*, Vol. 47 (5), 1249–1281.
- Dye, R. A. (1988) Earnings management in an overlapping generations model. *Journal of Accounting Research*, Vol. 26 (2), 195–235.
- Easterwood, C. M. (1998) Takeovers and incentives for earnings management: an empirical analysis. *Journal of Applied Business Research*, Vol. 14 (1), 29–48.
- EC Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.
- Efendi, J. – Srivastava, A. – Swanson, E. P. (2007) Why do corporate managers misstate financial statements? The role of option compensation, corporate governance, and other factors. *Journal of Financial Economics*, Vol. 83 (3), 667–708.

- Elliott, J. A. – Hanna, J. D. (1996) Repeated accounting write-offs and the information content of earnings. *Journal of Accounting Research*, Vol. 34 (3), 135–155.
- Elliott, J. A. – Shaw, W. A. (1988) Write-off as accounting procedures to manage perceptions. *Journal of Accounting Research*, Vol. 26 (3), 91–119.
- Entwistle, G. M. (1999) Exploring the R&D disclosure environment. *Accounting Horizons*, Vol. 13 (4), 323–341.
- Epstein, B. J. – Jermakowicz, E. K. (2007) *IFRS 2007: Interpretation and application of International Financial Reporting Standards*. John Wiley & Sons, Hoboken, New Jersey.
- Erickson, M. – Wang, S. (1999) Earnings management by acquiring firms in stock for stock mergers. *Journal of Accounting and Economics*, Vol. 27 (2), 149–176.
- Evans, J. H. – Sridhar S. S. (1996) Multiple control systems, accrual accounting, and earnings management. *Journal of Accounting Research*, Vol. 54 (1), 45–65.
- Ewert, R. – Wagenhofer, A. (2005) Economic effects of tightening accounting standards to restrict earnings management. *The Accounting Review*, Vol. 80 (4), 1101–1124.
- Fairfield, P. M. – Whisenant, S. J. – Yohn, T. L. (2003) Accrued earnings and growth: implications for future profitability and market mispricing. *The Accounting Review*, Vol. 78 (1), 353–371.
- Fairfield, P. M. – Yohn, T. (2001) Using asset turnover and profit margin to forecast changes in profitability. *Review of Accounting Studies*, Vol. 6 (4), 371–385.
- Fan, Y. – Barua, A. – Cready, W. M. – Thomas, W. B. (2010) Managing earnings using classification shifting: evidence from quarterly special items. *The Accounting Review*, Vol. 85 (4), 1303–1323.
- Feltham, G. A. – Ohlson, J. A. (1995) Valuation and clean surplus accounting for operating and financial activities. *Contemporary Accounting Research*, Vol. 11 (2), 689–731.
- Fields, T. D. – Lys, T. Z. – Vincent, L. (2001) Empirical research on accounting choice. *Journal of Accounting and Economics*, Vol. 31 (1–3), 255–307.
- Financial accounting standard board (1980) *Qualitative characteristics of accounting information*. Statement of financial accounting concepts No. 2. Stamford, FASB.
- Francis, J. (2001) Discussion of empirical research on accounting choice. *Journal of Accounting and Economics*, Vol. 31 (1–3), 309–319.
- Francis, J. – Hanna, J. D. – Vincent, L. (1996) Causes and effects of discretionary asset write-offs. *Journal of Accounting Research*, Vol. 34 (3), 117–134.
- Fudenberg, D. – Tirole, J. (1995) A theory of income and dividend smoothing based on incumbency rents. *Journal of Political Economy*, Vol. 103 (1), 75–93.

- Gaver, J. J. – Gaver, K. M. – Austin, J. R. (1995) Additional evidence on bonus plans and income management. *Journal of Accounting and Economics*, Vol. 19 (1), 3–28.
- Geiger, M. A. – North, D. S. (2006) Does hiring a new CFO change things? An investigation of changes in discretionary accruals. *The Accounting Review*, Vol. 81 (4), 781–809.
- Giroux, G. (2004) *Detecting earnings management*. John Wiley & Sons, Hoboken, New Jersey.
- Givoly, D. – Hayn, C. – D'Souza, J. (1999) Measurement errors and information content of segment reporting. *Review of Accounting Studies*, Vol. 4 (1), 15–43.
- Gonedes, N. J. (1978) Corporate signaling, external accounting, and capital market equilibrium: evidence on dividends, income and extraordinary items. *Journal of Accounting Research*, Vol. 16 (1), 26–79.
- Gonedes, N. J. – Dopuch, N. – Penman, S. H. (1976) Disclosure rules, information-production, and capital market equilibrium: the case of forecast disclosure rules. *Journal of Accounting Research*, Vol. 14 (1), 89–137.
- Graham, J. R. – Harvey, C. R. – Rajgopal, S. (2005) The economic implications of corporate financial reporting. *Journal of Accounting and Economics*, Vol. 40 (1–3), 3–73.
- Green, D. – Segall, J. (1966) The predictive power of first-quarter earnings reports: a replication. *Journal of Accounting Research*, Vol. 4 (3), 21–36.
- Gu, Z. – Chen, T. (2004) Analysts' treatment of nonrecurring items in street earnings. *Journal of Accounting and Economics*, Vol. 38 (Conference issue), 129–170.
- Guay, W. R. – Kothari, S. P. – Watts, R. L. (1996) A market-based evaluation of discretionary accrual models. *Journal of Accounting Research*, Vol. 34 (3), 83–105.
- Gunny, K. A. (2010) The relation between earnings management using real activities manipulation and future performance: evidence from meeting earnings benchmarks. *Contemporary Accounting Research*, Vol. 2 (3), 855–888.
- Hatfield, G. R. (2002) R&D in an EVA world. *Research Technology Management*, Vol. 45 (1), 41–47.
- Hayn, C. (1995) The information content of losses. *Journal of Accounting and Economics*, Vol. 20 (2), 125–149.
- Healy, P. M. (1985) The effect of bonus schemes on accounting decision. *Journal of Accounting and Economics*, Vol. 7 (1–3), 85–107.
- Healy, P. M. – Palepu, K. G. (1990) Effectiveness of accounting-based dividend covenants. *Journal of Accounting and Economics*, Vol. 12 (1–3), 97–123.
- Healy, P. M. – Palepu, K. G. (1993) The effect of firms' financial disclosure strategies on stock prices. *Accounting Horizons*, Vol. 7 (1), 1–11.

- Healy, P. M. – Wahlen, J. M. (1999) A review of the earnings management literature and its implications for standard setting. *Accounting Horizons*, Vol. 13 (4), 365–383.
- Hendriksen, E. S. (1982) *Accounting Theory*. Fourth ed. Irwin, Homewood.
- Herrmann, T. – Inoue, T. – Thomas, W. B. (2003) The sale of assets to manage earnings in Japan. *Journal of Accounting Research*, Vol. 41 (1), 89–108.
- Hicks, J. (1939) *Value and capital*. Oxford University Press, Oxford, U.K.
- Hines, R. D. (1988) Financial accounting: in communicating reality, we construct reality. *Accounting, Organizations and Society*, Vol. 13 (3), 251–261.
- Hines, R. D. (1991) The FASB's conceptual framework, financial accounting and the maintenance of the social world. *Accounting, Organizations and Society*, Vol. 16 (4), 313–331.
- Hirshleifer, D. – Teoh, S. H. (2009) The psychological attraction approach to accounting and disclosure policy. *Contemporary Accounting Research*, Vol. 26 (4), 1067–1090.
- Hodge, F. D. (2003) Investors' perceptions of earnings quality, auditor independence, and the usefulness of audited financial information. *Accounting Horizons*, Vol. 17 (Supplement), 37–48.
- Holthausen, R. W. (1990) Accounting method choice: opportunistic behavior, efficient contracting, and information perspectives. *Journal of Accounting and Economics*, Vol. 12 (1–3), 207–218.
- Holthausen, R. W. – Larcker, D. F. – Sloan, R. G. (1995) Annual bonus schemes and the manipulation of earnings. *Journal of Accounting and Economics*, Vol. 19 (1), 29–74.
- Holthausen, R. W. – Leftwich, R. W. (1983) The economic consequences of accounting choice. Implications of costly contracting and monitoring. *Journal of Accounting and Economics*, Vol. 5 (1–2), 77–117.
- Holthausen, R. W. – Watts, R. L. (2001) The relevance of the value-relevance literature for financial accounting standard setting. *Journal of Accounting and Economics*, Vol. 31 (1–3), 3–75.
- Hughes, P. J. – Schwartz, E. S. – Fellingham, J. (1988) The LIFO/FIFO choice: an asymmetric information approach. *Journal of Accounting Research*, Vol. 26 (3), 41–58.
- Ibrahim, S. S. (2010) The usefulness of measures of consistency of discretionary components of accruals in the detection of earnings management. *Journal of Business Finance & Accounting*, Vol. 36 (9–10), 1087–1116.
- Jackson, S. B. (2008) The effect of firms' depreciation method choice on managers' capital investment decisions. *The Accounting Review*, Vol. 83 (2), 351–376.
- Jackson, S. B. – Liu, X. K. (2010) The allowance for uncollectible accounts, conservatism, and earnings management. *Journal of Accounting Research*, Vol. 48 (3), 565–601.

- Jacob, J. – Jorgensen, B. N. (2007) Earnings management and accounting income aggregation. *Journal of Accounting and Economics*, Vol. 43 (2–3), 369–390.
- Jaggi, B. – Lee, P. (2002) Earnings management response to debt covenant violations and debt restructuring. *Journal of Accounting, Auditing & Finance*, Vol. 17 (4), 295–324.
- Jarva, H. (2010) Do firms manage fair value estimates? An examination of SFAS 142 goodwill impairments. *Journal of Business Finance & Accounting*, Vol. 36 (9–10), 1059–1086.
- Jeanjean, T. – Stolowy, H. (2008) Do accounting standards matter? An exploratory analysis of earnings management before and after IFRS adoption. *Journal of Accounting and Public Policy*, Vol. 27 (6), 480–494.
- Jensen, M. C. – Meckling, W. H. (1976) Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, Vol. 3 (4), 305–360.
- Jensen, M. J. (2001) Corporate budgeting is broken – let's fix it. *Harvard Business Review*, Vol. 79 (10), 94–101.
- Jiambalvo, J. (1996) Discussion of "Causes and consequences of earnings manipulation; an analysis of firms subject to enforcement actions by the SEC". *Contemporary Accounting Research*, Vol. 13 (1), 37–47.
- Jiang, J. – Petroni, K. R. – Wang, I. Y. (2010) CFOs and CEOs: who have the most influence on earnings management? *Journal of Financial Economics*, Vol. 96 (3), 513–526.
- Jones, J. J. (1991) Earnings management during import relief investigations. *Journal of Accounting Research*, Vol. 29 (2), 193–228.
- Jong, A., de – DeJong, D. V. – Mertens, G – Roosenboom, P. (2007) Investor relations, reputational bonding, and corporate governance: the case of Royal Ahold. *Journal of Accounting and Public Policy*, Vol. 26 (3), 328–375.
- Jorissen, A. – Otley, D. (2010) The management of accounting numbers: case study evidence from the "crash" of an airline. *Accounting and Business Research*, Vol. 40 (1), 3–38.
- Kang, S. H. – Sivaramakrishnan, K. (1995) Issues in testing earnings management and an instrumental variable approach. *Journal of Accounting Research*, Vol. 33 (2), 353–367.
- Kaplan, R. S. (2011) Accounting scholarship that advances professional knowledge and practice. *The Accounting Review*, Vol. 86 (2), 367–383.
- Kaszniak, R. – McNichols, M. F. (2002) Does meeting earnings expectations matter? Evidence from analyst forecast revisions and share prices. *Journal of Accounting Research*, Vol. 40 (3), 727–759.
- Keating, P. J. (1995) A framework for classifying and evaluating the theoretical contributions of case research in management accounting. *Journal of Management Accounting Research*, Vol. 7, 66–86.
- Keung, E. – Lin, Z. X. – Shih, M. (2010) Does the stock market see a zero or small positive earnings surprise as a red flag? *Journal of Accounting Research*, Vol. 48 (1), 105–135.

- Key, K. G. (1997) Political cost incentives for earnings management in the cable television industry. *Journal of Accounting and Economics*, Vol. 23 (3), 309–337.
- Kinney, M. – Trezevant, R. (1997) The use of special items to manage earnings and perceptions. *Journal of Financial Statement Analysis*, Vol. 3 (1), 45–53.
- Kirschenheiter, M. – Melumad, N. D. (2002) Can "big bath" and earnings smoothing co-exist as equilibrium financial reporting strategies? *Journal of Accounting Research*, Vol. 40 (3), 761–796.
- Kothari, S. P. – Leone, A. J. – Wasley, C. E. (2005) Performance matched discretionary accrual measures. *Journal of Accounting and Economics*, Vol. 39 (1), 163–197.
- Kothari, S. P. – Ramanna, K. – Skinner, D. J. (2010) Implications for GAAP from an analysis of positive research in accounting. *Journal of Accounting and Economics*, Vol. 50 (2–3), 246–286.
- Lambert, R. A. (1984) Income smoothing as rational equilibrium behavior. *The Accounting Review*, Vol. 59 (4), 604–618.
- Landry, S. – Callimaci, A. (2003) The effects of management incentives and cross-listing status on the accounting treatment of R&D spending. *Journal of International Accounting, Auditing & Taxation*, Vol. 12 (2), 131–152.
- Leuz, C. – Nanda, D. – Wysocki, P. D. (2003) Earnings management and investor protection: an international comparison. *Journal of Financial Economics*, Vol. 69 (3), 505–527.
- Lev, B. (2002) Where have all Enron's intangibles gone? *Journal of Accounting and Public Policy*, Vol. 21 (2), 131–135.
- Lewitt, A. (1998) The numbers game. *CPA Journal*, Vol. 68, 14–18.
- Liberty, S. E. – Zimmerman, J. L. (1986) Labor union contract negotiations and accounting choices. *The Accounting Review*, Vol. 61 (4), 692–712.
- Lipe, R. C. (1986) The information contained in the components of earnings. *Journal of Accounting Research*, Vol. 24 (3), 37–64.
- Lopez, T. J. – Rees, L. (2002) The effect of beating and missing analysts' forecasts on the information content of unexpected accruals. *Journal of Accounting, Auditing & Finance*, Vol. 17 (2), 155–184.
- Louis, H. (2004) Earnings management and the market performance of acquiring firms. *Journal of Financial Economics*, Vol. 74 (1), 121–148.
- Lukka, K. (2005) Approaches to case research in management accounting: the nature of empirical intervention and theory linkage. In: *Accounting in Scandinavia - the northern lights*, eds. S. Jönsson – J. Mouritsen, 375–399. Kristianstad: Liber & Copenhagen Business School Press.

- Lukka, K. – Kasanen, E. (1995) The problem of generalizability: anecdotes and evidence in accounting research. *Accounting, Auditing and Accountability Journal*, Vol. 8 (5), 71–90.
- Lys, T. – Vincent, L. (1995) An analysis of value destruction in AT&T's acquisition of NCR. *Journal of Financial Economics*, Vol. 39 (2–3), 353–378.
- Mackenzie, B. – Coe Tsee, D. – Njikizana, T. – Chamboko, R. – Colyvas, B. (2011) *2011 Interpretation and application of International Financial Reporting Standards*. John Wiley & Sons, Inc., Hoboken, New Jersey.
- Marquardt, C. A. – Wiedman, C. I. (2004) How are earnings managed? An examination of specific accruals. *Contemporary Accounting Research*, Vol. 21 (2), 461–491.
- Martin, J. – Feldman, M. S. – Hatch, M. J. – Sitkin, S. B. (1983) The uniqueness paradox in organizational stories. *Administrative Science Quarterly*, Vol. 28 (3), 438–453.
- Matsunaga, S. – Park, C. (2001) The effect of missing quarterly earnings benchmark on the CEO's annual bonus. *The Accounting Review*, Vol. 76 (3), 313–332.
- McKinnon, J. (1988) Reliability and validity in field research: some strategies and tactics. *Accounting, Auditing, and Accountability Journal*, Vol. 1 (1), 34–54.
- McNichols, M. F. (2000) Research design issues in earnings management studies. *Journal of Accounting and Public Policy*, Vol. 19 (4–5), 313–345.
- McNichols, M. F. – Wilson, P. G. (1988) Evidence of earnings management from the provision for bad debts. *Journal of Accounting Research*, Vol. 26 (3), 1–31.
- McVay, S. E. (2006) Earnings management using classification shifting: an examination of core earnings and special items. *The Accounting Review*, Vol. 81 (3), 501–531.
- Moyer, S. E. (1990) Capital adequacy ratio regulations and accounting choices in commercial banks. *Journal of Accounting and Economics*, Vol. 13 (2), 123–154.
- Muller, K. A. – Neamtiu, M. – Riedl, E. J. (2009) *Insider trading preceding goodwill impairments*. Working paper, Harvard Business School.
- Murphy, K. J. – Zimmerman, J. L. (1993) Financial performance surrounding CEO turnover. *Journal of Accounting and Economics*, Vol. 16 (1–3), 273–315.
- Neil, J. D. – Pourciau, S. G. – Schaefer, T. F. (1995) Accounting method choice and IPO valuation. *Accounting Horizons*, Vol. 9 (3), 68–80.

- Nelson, K. K. (2000) Rate regulation, competition, and loss reserve discounting by property-casualty insurers. *The Accounting Review*, Vol. 75 (1), 115–118.
- Nelson, M. W. (2003) Behavioral evidence on the effects of principles- and rules-based standards. *Accounting Horizons*, Vol. 17 (1), 91–104.
- Nelson, M. W. – Elliott, J. A. – Tarpley, R. L. (2002) Evidence from auditors about managers' and auditors' earnings management decision. *The Accounting Review*, Vol. 77 (4), 175–202.
- Nelson, M. W. – Elliott, J. A. – Tarpley, R. L. (2003) How are earnings managed? Examples from auditors. *Accounting Horizons*, Vol. 17 (Supplement), 17–35.
- Ohlson, J. A. (1995) Earnings, book values, and dividends in security valuation. *Contemporary Accounting Research*, Vol. 11 (2), 661–687.
- Oswald, D. R. – Zarowin, P. (2007) Capitalization vs. expensing of R&D and earnings management. *European Accounting Review*, Vol. 16 (4), 703–726.
- Ou, J. A. (1990) The information content of nonearnings accounting numbers as earnings predictors. *Journal of Accounting Research*, Vol. 28 (1), 144–163.
- Ou, J. A. – Penman, S. H. (1989) Financial statement analysis and the prediction of stock returns. *Journal of Accounting and Economics*, Vol. 11 (4), 295–329.
- Peasnell, K. V. – Pope, P. F. – Young, S. (2000) Detecting earnings management using cross-sectional abnormal accruals models. *Accounting and Business Research*, Vol. 30 (4), 313–326.
- Penman, S. (2001) *Financial statement analysis and security valuation*. McGraw-Hill Irwin, New York.
- Perry, S. E. – Williams, T. H. (1994) Earnings management preceding management buyout offers. *Journal of Accounting and Economics*, Vol. 18 (2), 157–179.
- Petroni, K. R. (1992) Optimistic reporting in the property-casualty insurance industry. *Journal of Accounting and Economics*, Vol. 15 (4), 485–508.
- Petroni, K. R. – Ryan, S. G. – Wahlen, J. M. (2000) Discretionary and non-discretionary revisions of loss reserves by property-casualty insurers: differential implications for future profitability, risk and market value. *Review of Accounting Studies*, Vol. 5 (2), 95–125.
- Philips, J. – Pincus, M. – Rego, S. O. (2003) Earnings management: new evidence based on deferred tax expense. *The Accounting Review*, Vol. 78 (2), 491–521.

- Plummer, E. – Mest, D. P. (2001) Evidence on the management of earnings components. *Journal of Accounting, Auditing & Finance*, Vol. 16 (4), 301–323.
- Pourciau, S. (1993) Earnings management and nonroutine executive changes. *Journal of Accounting and Economics*, Vol. 16 (1–3), 317–336.
- Ramanna, K. (2008) The implications of unverifiable fair-value accounting: evidence from the political economy of goodwill accounting. *Journal of Accounting and Economics*, Vol. 45 (2–3), 253–281.
- Ramanna, K. – Watts, R. L. (2009) *Evidence from goodwill non-impairments on the effects of using unverifiable estimates in financial reporting*. Working paper, Harvard Business School.
- Rees, L. – Gill, S. – Gore, R. (1996) An investigation of asset write-downs and concurrent abnormal accruals. *Journal of Accounting Research*, Vol. 34 (3), 157–169.
- Richardson, V. J. (2000) Information asymmetry and earnings management: some evidence. *Review of Quantitative Finance and Accounting*, Vol. 15 (4), 325–347.
- Ronen, J. – Yaari, V. (2008) *Earnings management. Emerging insights in theory, practice, and research*. Springer, New York.
- Roychowdhury, R. (2006) Earnings management through real activities manipulation. *Journal of Accounting and Economics*, Vol. 42 (3), 335–370.
- Russo, J. E. – Medvec, V. H. – Meloy, M. G. (1996) The distortion of information during decisions. *Organizational Behavior and Human Decision Processes*, Vol. 66 (1), 102–110.
- Scapens, R. W. (1990) Researching management accounting practice: the role of case study methods. *British Accounting Review*, Vol. 22 (3), 259–281.
- Schipper, K. (1989) Commentary on earnings management. *Accounting Horizons* Vol. 3 (4), 91–102.
- Schipper, K. – Vincent, L. (2003) Earnings quality. *Accounting Horizons*, Vol. 17 (Supplement), 97–110.
- Scott, W. R. (2009) *Financial accounting theory*. Fifth ed. Prentice Hall, Upper Saddle River, New Jersey.
- Seybert, N. (2010) R&D capitalization and reputation-driven real earnings management. *The Accounting Review*, Vol. 85 (2), 671–693.
- Silverman, D. (1985) *Qualitative methodology and sociology*. Gower, Aldershot.
- Skinner, D. J. – Sloan, R. G. (2002) Earnings surprises, growth expectations, and stock returns or don't let earnings torpedo sink your portfolio. *Review of Accounting Studies*, Vol. 7 (2–3), 289–312.
- Sloan, R. G. (1996) Do stock prices fully reflect information in accruals and cash flows about future earnings? *The Accounting Review*, Vol. 71 (3), 289–315.

- Spence, M. (1973) Job market signaling. *Quarterly Journal of Economics*, Vol. 87 (3), 355–374.
- Spicer, B. H. (1992) The resurgence of cost and management accounting: a review of some recent developments in practice, theories and case research methods. *Management Accounting Research*, Vol. 3 (1) 1–37.
- Stiglitz, J. E. (1975) The theory of “screening”, education, and the distribution of income. *The American Economic Review*, Vol. 65 (3), 283–300.
- Strong, J. S. – Meyer, J. R. (1987) Asset writedowns: managerial incentives and security returns. *Journal of Finance*, Vol. 42 (3), 643–661.
- Stubben, S. R. (2010) Discretionary revenues as a measure of earnings management. *The Accounting Review*, Vol. 85 (2), 695–717.
- Subramanyam, K. R. (1996) The pricing of discretionary accruals. *Journal of Accounting and Economics*, Vol. 22 (1–3), 249–281.
- Sweeney, A. P. (1994) Debt-covenant violations and managers' accounting responses. *Journal of Accounting and Economics*, Vol. 17 (3), 281–308.
- Taylor, W. B. (2010) The balanced scorecard as a strategy evaluation tool: the effects of implementation involvement and a causal chain focus. *The Accounting Review*, Vol. 85 (3), 1095–1117.
- Teoh, S. H. – Welch, I. – Wong, T. J. (1998a) Earnings management and the underperformance of seasoned equity offerings. *Journal of Financial Economics*, Vol. 50 (1), 63–99.
- Teoh, S. H. – Welch, I. – Wong, T. J. (1998b) Earnings management and the long-run market performance of initial public offerings. *Journal of Finance*, Vol. 53 (6), 1935–1974.
- Thomas, J. K. – Zhang, X. J. (2000) Identifying unexpected accruals: a comparison of current approaches. *Journal of Accounting and Public Policy*, Vol. 19 (4–5), 347–376.
- Trueman, B. – Titman, S. (1988) An explanation for accounting income smoothing. *Journal of Accounting Research*, Vol. 26 (3), 127–139.
- Watts, R. L. (2003) Conservatism in accounting part 1: explanations and implications. *Accounting Horizons*, Vol. 17 (3), 207–221.
- Watts, R. L. – Zimmerman, J. L. (1978) Towards a positive accounting theory of the determination of accounting standards. *The Accounting Review*, Vol. 53 (1), 112–134.
- Watts, R. L. – Zimmerman, J. L. (1979) The demand and supply of accounting theories: The market for excuses. *The Accounting Review*, Vol. 54 (2), 273–305.
- Watts, R. L. – Zimmerman J. L. (1986) *Positive accounting theory*. Prentice Hall, Englewood Cliffs.

- Watts, R. L. – Zimmerman J. L. (1990) Positive accounting theory: a ten year perspective. *The Accounting Review*, Vol. 65 (1), 131–156.
- Wilson, M. – Shailer, G. (2007) Accounting manipulations and political costs: Tooth & Co Ltd, 1910–1965. *Accounting and Business Research*, Vol. 37 (4), 247–266.
- Wilson, P. G. (1996) Discussion: write-offs: manipulation or impairment? *Journal of Accounting Research*, Vol. 34 (3), 171–177.
- Xie, H. (2001) The mispricing of abnormal accruals. *The Accounting Review*, Vol. 76 (3), 357–373.
- Yin, R. K. (1984) *Case study research: design and methods*. Sage Publications, London.

APPENDIX: INTERVIEW DATA

Person (position in which interviewed)	Date	Interview method	Interview time
1. CFO	6.11.2006	Theme	2:05
2. CFO	20.4.2007	Semi structured	3:25
3. CEO	27.4.2007	Semi structured	1:30
4. Financial manager /controller A	26.6.2007	Semi structured	2:20
5. Business unit B manager	29.6.2007	Semi structured	1:25
6. Chief accountant	18.9.2007	Semi structured	0:50
7. Business unit B controller	31.10.2007	Semi structured	2:00
8. CFO	6.11.2007	Semi structured	2:00
9. Authorized Public Accountant (x)	9.11.2007	Semi Structured	1:40
10. Principal Auditor of the case	20.11.2007	Semi structured	1:15
11. CFO	28.2.2008	Semi structured	2:10
12. Financial manager	8.4.2008	Semi structured	1:45
13. CFO	21.5.2008	Semi structured	1:35
14. CEO	29.5.2008	Semi structured	1:30
15. Authorized Public Accountant (x)	3.6.2008	Semi structured	1:45
16. CFO	15.7.2008	Semi structured	2:10
17. Financial manager	23.7.2008	Semi structured	2:35
18. CFO	19.8.2008	Semi structured	1:50
19. CFO	12.12.2008	Semi structured	1:25
20. Authorized Public Accountant (x)	6.2.2009	Semi structured	1:40
21. CFO	12.2.2009	Semi structured	1:00
22. Authorized Public Accountant (y)	6.11.2009	Semi structured	1:55

**TURUN KAUPPAKORKEAKOULUN JULKAISUSARJASSA A OVAT
VUODESTA 2011 LÄHTIEN ILMESTYNEET SEURAAVAT JULKAISUT**

- A-1:2011 Marjo Kumpula
Vakuutusalan työn sisältö ja työntekijöiden ammatti-identiteetin muovautuvuus – Vakuutusvirkailijasta finanssialan myyjäksi?
- A-2:2011 Helena Keinänen
Algorithms for coalitional games
- A-3:2011 Matti Mäntymäki
Continuous use and purchasing behaviour in social virtual worlds
- A-4:2011 Arto Kuuluvainen
Dynamic capabilities in the international growth of small and medium-sized firms
- A-5:2011 Ville Korpela
Four essays on implementation theory
- A-6:2011 Leena Aarikka-Stenroos
Reference communication and third actors in the initiation of business relationships
- A-7:2011 Jouni Suominen
Kohti oppivaa organisaatiota – Konstruktion muodostaminen johtamisen ja oppimisen välisistä riippuvuusuhteista
- A-8:2011 Samuli Leppälä
Essays in the economics of knowledge
- A-9:2011 Nina Stenström-Iivarinen
The communication of strategically significant topics in business-to-business relationships: An empirical study in the electronics manufacturing industry
- A-10:2011 Katja Heikkilä
A business-network view on managing MNC relationships with state actors – Russian public officials in Finnish MNC business networks
-
- A-1:2012 Aleksandra Masłowska
Studies on institutions and central bank independence
- A-2:2012 Salla Laasonen
Corporate responsibility guaranteed by dialogue? Examining the relationship between nongovernmental organizations and business
- A-3:2012 Mikko Kepsu
Earnings management in the process of preparing corporate financial reports

Kaikkia edellä mainittuja sekä muita Turun kauppakorkeakoulun julkaisusarjoissa ilmestyneitä julkaisuja voi tilata osoitteella:

KY-Dealing Oy
Rehtorinpellonkatu 3
20500 Turku
Puh. (02) 333 9422
E-mail: ky-dealing@tse.fi

All the publications can be ordered from

KY-Dealing Oy
Rehtorinpellonkatu 3
20500 Turku, Finland
Phone +358-2-333 9422
E-mail: ky-dealing@tse.fi