

Earnings conservatism and earnings management in accounting standards

- **what's the link between earnings conservatism & earnings management?**
 - conservatism reduces current profits
 - management tends to increase profits
- **how can both be true?**
- **consider MM61 valuation model**
 - value from *future* assets
 - not in accounting system, so E cannot reflect this, good or bad news
 - value from *existing* assets
 - potential for conservatism and management
- **sometimes different sides of the same coin**
 - conservatism in the regulations
 - management in the application of regulations

Example of the link between conservatism & management: Stock write downs

<u>Assets</u>		<u>Liabilities</u>	
Stock	-10		
		Reserves	
		P&L	-10

- **write stock down as exceptional item**
- **example of conservatism**
- **but stock now at low value in BS. If sell, then profits high. Transfer of profits from one period to next**
- **hence big bath accounting**
 - market does not really distinguish between *size* of losses
 - just bad news all round
 - so incentive to take future costs to the P&L this year

Some accounting not conservative at all: capitalisation of costs

<u>Assets</u>		<u>Liabilities</u>
Bank	-10	
Assets	+10	Reserves
		P&L

- **PFI work, bidding costs can be capitalised**
- **can be large, and if contract not awarded, need to be charged to P&L**
- **Amey**
 - 2001 costs capitalised, profit £55m
 - 2002 not capitalised, changed to £18m loss
 - in 2000, operating profit of £30m but cash flow of £7m
- **Enron also capitalised costs**
- **hence regulations not conservative, almost encourage earnings management**

Differences in conservatism between IFRS & USGAAP

- **reversal of stock write down**
 - IFRS, required
 - US prohibited, ultra conservative
- **inspection-overhaul costs**
 - IFRS, allowed as asset, not conservative
 - US expensed
- **fixed assets**
 - US historical cost, conservative but giving large gains to P&L if sold (not conservative)
 - IFRS, revaluation allowed, typically to reserves which not recycled on sale
 - example

- **example**
 - company has asset 200
 - revalue to 250
 - sell for 310
 - 60 in P&L
 - the 50 revaluation gain remains in reserves

<u>Assets</u>		<u>Liabilities</u>	
Bank	310		
Assets	200+50	Reserves	+50
	-250	P&L	+60

- **purchased R&D**
 - IFRS, capitalised and amortised
 - US, expensed
- **goodwill and non R&D intangibles**
 - IFRS, capitalised and amortised over ≤ 20 years
 - US, capitalised and impairment test applied (more subjective than amortisation)
- **impairment test**
 - US, if value $>$ *undiscounted* cash flows
 - bias against not recognising impairments
- **consolidation**
 - IFRS, control
 - US majority voting rights (Enron)