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John Paul
CUNY Brooklyn College, john.paul@brooklyn.cuny.edu

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⁹³ H.R. 1873; S. 987.

⁹⁴ No. 10-948; 615 F. 3d 1204; 2010 U.S. App. LEXIS 17128 (9th Cir., 2010). In this case, the Court must decide if a mandatory arbitration clause in a consumer contract trumps an explicit statutory right to sue that was created under the Credit Card Accountability, Responsibility and Disclosure Act of 2009.

⁹⁵ Kate Davidson, *High Court Gives Banks A Win, But Will It Last?*, 176 AMERICAN BANKER 1 n. 66 (April 28, 2011).

HOW THE LEGAL ENVIRONMENT AFFECTS EARNINGS MANAGEMENT

by

John Paul^{*}

INTRODUCTION

Earnings management has been on the rise. The recent corporate accounting scandals involving large well-known companies such as Enron, WorldCom, Xerox and Tyco – all audited by large accounting firms – suggest serious deficiencies in the accounting standards and corporate governance and regulatory systems designed to guide and monitor the financial information process.¹ While large firms may have received more media attention, financial statement fraud occurred more frequently in smaller companies (companies with total assets of less than \$100 million) than larger ones.²

Since earnings management has been on the rise, a definition of earnings management is in order. Earnings management is when managers alter their entities' accounting and financial information by using their discretion in financial reporting and transaction structuring.

^{*} Clinical Assistant Professor of Accounting/Legal Studies and Taxation
Lubin School of Business, Pace University – New York

Firm-specific data corroborates the use of earnings management by corporations. The number of earnings restatements by listed companies, often after admitted irregularities, has tremendously increased in the last several years.³ In addition, the frequency of firms beating analyst's earnings forecasts has increased sharply in the 1990s, suggesting earnings management as a possible cause.⁴ Lev and Zarowin provide evidence that the usefulness of reported earnings, cash flows, and equity values has been deteriorating for two decades.⁵

One common form of earnings management is the use of discretionary accruals.⁶ Under accrual-basis accounting, transactions that change a firm's financial statements are recorded in the same periods in which the events occur. Under the accrual basis, revenues are recognized when earned rather than when the cash is actually received and expenses are recognized when incurred rather than when the cash is paid. On an accrual basis, information presented reveals relationships likely to be important in predicting future results.

Under cash-basis accounting, revenues are recorded only when received in cash and expenses are recorded only when paid in cash. Cash-basis accounting does not properly match earned revenues with expenses and is not in accordance with Generally Accepted Accounting Principles. Cash basis accounting is justified for individuals and small companies because they usually have few receivables and payables but most companies use accrual-basis accounting.⁷ Accruals, in particular, are the non-cash items that determine regular accounting income.⁸

By their very nature, accruals require subjective judgments and estimation. Before they are realized, accruals are difficult for auditors to objectively verify.⁹ Determining what

component of accruals is discretionary is also difficult but empirical models have been developed to measure discretionary accruals.¹⁰

Researchers have found many incentives for using discretionary accruals as a form of earnings management. Many corporate contracts use accounting information as a means of assessing whether the contract terms are being followed. For example, in some employment contracts, firm managers do not receive any bonuses in years where their firms suffer losses or where certain earnings targets are not met.¹¹ These types of contracts provide incentives for managers to inflate earnings in order to receive the maximum amount of compensation that may be available to them.

There are also regulatory incentives for using discretionary accruals. In the United States some industries, such as the banking, insurance and utility industries, face regulation that is specifically tied to numbers. In particular, banks are required by regulation to maintain certain capital adequacy requirements while utility companies are rate-regulated and allowed to earn only a normal return on invested assets. These regulations provide incentives to manage the financial statement variables.¹² Evidence indicates that banks close to minimum capital requirements recognize abnormal realized gains on securities portfolios.¹³

This leads to the issue of how a fraud-based legal ruling would impact the managerial incentive for earnings management using discretionary accruals. Arguably, a ruling would decrease the incentive for using discretionary accruals since firm managers would not want to go through the ordeal of another legal action; yet, it can also be argued that such a ruling may provide more incentives for managers to use discretionary accruals since the legal case has been concluded

and the managers are faced with trying to place the corporation into a more favorable light in the eyes of stakeholders (i.e., creditors, stockholders, employees).

This study empirically examines how fraud-based legal rulings impact discretionary accruals. The results indicate that the magnitude of a firm's discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling and increases in response to the issuance of an unfavorable fraud-based legal ruling.

RESEARCH DESIGN

A sample of firms facing fraud-based legal rulings was selected by searching the Commerce Clearinghouse Federal Securities Law Reports for the years 1982 to 2007. Accounting data needed to estimate accruals¹⁴ was obtained from the Compustat Industrial Quarterly database.

The main proxy for client managers' reporting flexibility are the income-increasing discretionary accruals estimated using the Modified Jones model because while other models may provide better results in certain manipulation tests, the Modified Jones model is consistently better overall for measuring discretionary accruals and in detecting earnings management than other models are.¹⁵ The Modified Jones model estimates discretionary accruals (**DISCRETIONARY_ACCRUALS**) as the prediction error from firm-specific ordinary least square regressions:

$$(1) \text{TOTAL_ACCRUALS}_{it} = A_0 + A_1(\Delta \text{REV}_{it} - \Delta \text{REC}_{it}) + A_2(\text{PPE}_{it}) + \varepsilon_{it}$$

where:

TOTAL_ACCRUALS_{it} = $\Delta \text{Current assets}_t - \Delta \text{Cash}_t - \Delta \text{Current liabilities}_t + \Delta \text{Current portion of long-term debt}_t - \Delta \text{Depreciation and amortization expense}_t$;

A₀ = the intercept or an item of the regression equation indicating the criterion score when all the predictor variables are zero¹⁶;

ΔREV_{it} = revenues in year *t* less revenues in year *t*-1;

ΔREC_{it} = receivables in year *t* less receivables in year *t*-1;

PPE_{it} = gross property, plant and equipment in year *t*;

ε_{it} = prediction errors;

i = 1..n firm index; and

t = 1..T(*i*) year index for the number of years included in the estimation period for firm *i*.

DISCRETIONARY_ACCRUALS are the prediction errors (ε_{it}) from applying the Modified Jones model to estimate normal accruals in the year of the legal ruling:

$$(2) \text{DISCRETIONARY_ACCRUALS}_{it} = \text{TOTAL_ACCRUALS}_{it} - A_0 + A_1(\Delta \text{REV}_{it} - \Delta \text{REC}_{it}) + \text{PPE}_{it}$$

The discretionary accruals model specifies four control variables and two categorical variables. The four control variables represent earnings growth, firm growth, firm leverage and firm size. The two categorical variables are independent dummy variables used to account for the effect that the filing of a legal action and the issuance of a legal ruling have in predicting the dependent variable of discretionary accruals.

EMPIRICAL RESULTS

Table 1 summarizes the mean, standard deviation as well as the minimum and maximum values for the dependent and independent variables categorized by type of ruling – favorable and unfavorable. Table 2 summarizes the value of the regression coefficients, which indicate how much change occurs in the dependent variable of discretionary accruals for a one-unit change in the particular independent variable.

Table 1 reveals that the firms that received unfavorable rulings had a wider range of discretionary accruals when compared with the firms that received favorable rulings. Table 2 reveals that the companies with unfavorable rulings increased the use of income-increasing discretionary accruals by 80.27% $[(72.1394 - 40.0185)/40.0185\%]$ in the period after the issuance of the unfavorable legal ruling when compared to the period before the issuance of that ruling while the companies with favorable rulings decreased the use of income-increasing discretionary accruals by 96.26 percent $[(12.9523 - 346.7699)/346.7699\%]$ in a direct comparison of the (RULING = -1) and (RULING = 0) variables.

These results indicate that when companies prevail in fraud-based legal actions against them, they are more likely to decrease the use of discretionary accruals while companies that lose in fraud-based legal actions against them are more likely to increase the use of discretionary accruals. Perhaps the companies with favorable rulings are relieved at the fact they have won the fraud-based legal action and decrease the use of discretionary accruals so they won't have to face another such action again. Furthermore, the companies with unfavorable rulings now have to deal with a loss of trust among corporate stakeholders as a result of losing the legal action and use

discretionary accruals in order to provide a more impressive financial picture of the company so as to minimize the impact of the unfavorable ruling.

**TABLE 1:
DESCRIPTIVE STATISTICS
FOR
COMPANIES
WITH
FAVORABLE AND UNFAVORABLE
RULINGS**

<i>Companies with Favorable Rulings Sample = 27 Companies</i>		
Variable	Minimum	Maximum
FEarnGrowth	-887.6204	130.6226
FGrowth	-0.8064516	8.709299
FLeverage	0	7.31992
FSize	-0.1432711	5.979368
DiscAccr	-21,455.4	22,146.85
<i>Companies with Unfavorable Rulings Sample = 42 Companies</i>		
Variable	Minimum	Maximum
FEarnGrowth	-1,598	92.17647
FGrowth	-0.9851179	4.738058
FLeverage	6.849315	21.1
FSize	-1.920819	5.922928
DiscAccr	-44,445.42	32,965.52

**TABLE 2:
REGRESSION COEFFICIENTS FOR
THE RULING VARIABLES**

RULING TYPE	RULING = -1	RULING = 0
Favorable	346.7699	12.9523
Unfavorable	40.0185	72.1394

CONCLUSION

The use of earnings management has been on the rise for the past two decades. Earnings management is when managers alter corporate financial reports by exercising their discretion over accounting and financial issues. The use of discretionary accruals is a popular form of earnings management because they are difficult for independent auditors to verify since they involve subjective managerial estimates. Empirical models have been developed to measure the discretionary component of accruals.

Since there are empirical models that can measure discretionary accruals, the next step is to determine the incentives for the use of discretionary accruals. Studies of possible incentives include contractual and regulatory incentives among others. This study examines the incentives of firms to use discretionary accruals after they have received fraud-based legal rulings from a court or enforcement authority.

For the purposes of this study, a discretionary accrual model was formulated to test whether the magnitude of a firm's

discretionary accruals increases or decreases after the issuance of a fraud-based legal ruling. The results indicate that overall, the magnitude of a firm's discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling and increases in response to the issuance of an unfavorable fraud-based legal ruling.

It would seem that a firm that has received an unfavorable legal ruling may have no choice but to continue to use discretionary accruals in order to reduce its political visibility. According to the political cost hypothesis,¹⁷ a firm's reported earnings may increase its political visibility, which increases that firm's regulatory costs, bookkeeping costs, taxes and wage claims. As a result, a firm that has been issued an unfavorable legal ruling may use discretionary accruals to reduce its costs and political visibility among the stakeholders.¹⁸

In light of this study, independent auditors may need to address certain issues when dealing with firms that have just received fraud-based legal rulings. They should carefully examine managerial decisions that involve subjective estimates such as the Allowance for Bad Debts (or Allowance for Doubtful Accounts) to see if these decisions were made recently. The independent auditors should ask for extensive documentation and detailed explanations to support subjective managerial estimates. If these estimates appeared to have changed around the time the legal ruling was issued, the auditors should investigate further into the reasons for this change and why it coincided with the legal ruling.

Overall, this study provides useful information about the impact of the legal process on earnings management and the reliability of financial statements. An examination of the role that litigation plays in the accounting information process is necessary in order to increase the quality of such information

especially in a world characterized by increasing amounts of litigation.

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OFF-DUTY EMPLOYEE FRATERNIZATION INVADES THE OFFICE: A CASE STUDY OF DOSIS PHARMACEUTICALS

by

Nancy Lasher* and Donna Steslow**

INTRODUCTION:

Managers continue to struggle with defining appropriate interpersonal conduct between employees, and taking action when dating and relationships cross the line into a hostile work environment. Likewise, employment law attorneys are increasingly faced with giving advice in these situations and defining what is legal and illegal. Providing a scenario in the workplace involving a relationship between an administrative assistant and a professional can illustrate to business majors some of the issues raised in workplace relationships.

This case involves employment law and HR issues arising out of an affair between two employees at a pharmaceutical plant. The case is based upon an actual situation; however, the names of the parties, some of the descriptive facts, and the type of manufacturing plant have been changed for reasons of confidentiality. The affair ends badly and the tension and animosity between the male engineer and female administrative assistant is affecting the morale of the entire

* Assistant Professor, College of New Jersey,

** Assistant Professor, Kutztown University

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