CONTENTS

LIST OF CONTRIBUTORS ix

EDITORIAL BOARD xiii

LEARNERS AS DESIGNERS OF EDUCATIONAL HYPERMEDIA IN ACCOUNTING Janice L. Ammons and Sherry K. Mills 1

MAKE STUDENT FEEDBACK MEANINGFUL: "CUSTOMIZING" COURSE CRITIQUES John M. Thornton and Martin J. Hornyak 27

A FUNDAMENTAL APPROACH TO TEACHING ACCOUNTING VALUATION Albert H. Frakes and Thomas R. Nunamaker 43

THE USE OF PEER TUTORS IN INTRODUCTORY FINANCIAL ACCOUNTING Jane Dillard-Eggers and Thomas C. Wooten 55

HOW TO STIMULATE LEARNING IN LARGE CLASSES Karla Kay Jensen and Joann R. Segovia 81

<table>
<thead>
<tr>
<th>Title</th>
<th>Authors</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASSESSMENT OF INTRODUCTORY ACCOUNTING COURSES: THE KEY TO CONTINUOUS IMPROVEMENT</td>
<td>Michael F. Cornick, Sak Bhamornsiri and Edward G. Malngren</td>
<td>121</td>
</tr>
<tr>
<td>CORE COMPETENCIES: MAPPING THE VISION-ALIGNED ACADEMIC FRAMEWORK INTO THE VISION PROJECT</td>
<td>Noah P. Barsky, Dawn W. Massey and Jay C. Thibodeau</td>
<td>129</td>
</tr>
<tr>
<td>EFFECTIVE ACCOUNTING INSTRUCTION: A COMPARISON OF INSTRUCTOR PRACTICES AND STUDENT PERSPECTIVES</td>
<td>David S. Kerr and L. Murphy Smith</td>
<td>143</td>
</tr>
<tr>
<td>VALIDITY CHECK ON THE ACCOUNTING PREREQUISITES WITHIN THE BUSINESS CURRICULUM</td>
<td>Howard Turetsky and Gerald Weinstein</td>
<td>165</td>
</tr>
<tr>
<td>STUDENTS' PERCEPTIONS OF LEARNING IN A WEB-ASSISTED FINANCIAL STATEMENT ANALYSIS COURSE</td>
<td>Mohammad Abdolmohammadi, Martha Howe and Kenneth Ryack</td>
<td>181</td>
</tr>
<tr>
<td>WHAT SHOULD ACCOUNTING DOCTORAL PROGRAMS FOCUS ON? AN ECONOMIC PERSPECTIVE</td>
<td>Rajib Doogar</td>
<td>199</td>
</tr>
<tr>
<td>RETHINKING AIS: AN INNOVATIVE FINANCIAL INFORMATION SYSTEMS CURRICULUM</td>
<td>Joseph H. Callaghan, Arline Savage and Eileen Peacock</td>
<td>211</td>
</tr>
<tr>
<td>USING PROBLEM-BASED LEARNING TO PROMOTE SKILL DEVELOPMENT IN THE ACCOUNTING CLASSROOM</td>
<td>Cindy D. Edmonds, Thomas P. Edmonds and Elizabeth V. Mulig</td>
<td>229</td>
</tr>
<tr>
<td>CREATING A CUSTOM-PUBLISHED TEXTBOOK TO FACILITATE CURRICULUM CHANGE: AN EXAMPLE FROM ADVANCED ACCOUNTING</td>
<td>Dawn W. Massey and Joan Van Hise</td>
<td>243</td>
</tr>
<tr>
<td>COOKING THE BOOKS OR MANAGING EARNINGS: STUDENTS DRAW THE LINE</td>
<td>Lourdes F. White</td>
<td>263</td>
</tr>
<tr>
<td>A BEGINNER'S GUIDE TO INTERNET-ENHANCED FINANCIAL ACCOUNTING COURSES</td>
<td>Roann R. Kopel and Lola W. Dudley</td>
<td>289</td>
</tr>
<tr>
<td>Contribution</td>
<td>Institution</td>
<td></td>
</tr>
<tr>
<td>--------------</td>
<td>----------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Mohammad Abdolmohammadi</td>
<td>Department of Accountancy, Bentley College, USA</td>
<td></td>
</tr>
<tr>
<td>Janice L. Ammons</td>
<td>School of Business, Quinnipiac University, USA</td>
<td></td>
</tr>
<tr>
<td>Noah P. Barsky</td>
<td>College of Commerce and Finance, Villanova University, USA</td>
<td></td>
</tr>
<tr>
<td>Sak Bhamornsiri</td>
<td>Department of Accounting, University of North Carolina, Charlotte, USA</td>
<td></td>
</tr>
<tr>
<td>Joseph H. Callaghan</td>
<td>Department of Accounting and Finance, Oakland University, USA</td>
<td></td>
</tr>
<tr>
<td>Gail L. Cook</td>
<td>Department of Accounting and Finance, Brock University, Canada</td>
<td></td>
</tr>
<tr>
<td>Michael F. Cornick</td>
<td>Department of Accounting, Finance and Economics, Winthrop University, USA</td>
<td></td>
</tr>
<tr>
<td>Curtis L. DeBerg</td>
<td>Department of Accounting and Management, Information Systems, California State University-Chico, USA</td>
<td></td>
</tr>
<tr>
<td>Jane Dillard-Eggers</td>
<td>Massey School of Business, Belmont University, USA</td>
<td></td>
</tr>
<tr>
<td>Rajib Doogar</td>
<td>Department of Accountancy, University of Illinois at Urbana-Champaign, USA</td>
<td></td>
</tr>
<tr>
<td>Lola W. Dudley</td>
<td>School of Business, Eastern Illinois University, USA</td>
<td></td>
</tr>
<tr>
<td>Cindy D. Edmonds</td>
<td>Accounting and Information Systems, University of Alabama at Birmingham, USA</td>
<td></td>
</tr>
<tr>
<td>Thomas P. Edmonds</td>
<td>Accounting and Information Systems, University of Alabama at Birmingham, USA</td>
<td></td>
</tr>
</tbody>
</table>
Albert H. Frakes  
School of Accounting, Information Systems and Business Law, Washington State University, USA

Martin J. Hornyak  
Department of Management/MIS, University of West Florida, USA

Martha Howe  
Department of Accountancy, Bentley College, USA

Karla Kay Jensen  
Department of Communication Studies, Nebraska Wesleyan University, USA

David S. Kerr  
Department of Accounting, Texas A&M University, USA

Roann R. Kopel  
School of Business, Eastern Illinois University, USA

Edward G. Malmgren  
Department of Accounting, University of North Carolina Charlotte, USA

Dawn W. Massey  
Charles F. Dolan School of Business, Fairfield University, USA

Alfred R. Michenzi  
Department of Accounting, Loyola College in Maryland, Sellinger School of Business and Management, USA

Bernard J. Milano  
KPMG Foundation, USA

Sherry K. Mills  
Department of Accounting and Business Computer Systems, College of Business Administration and Economics, Mexico State University, USA

Elizabeth V. Mulig  
Department of Accounting and Business Law, Louisiana State University in Shreveport, College of Business, USA

Thomas R. Nunamaker  
School of Accounting, Information Systems and Business Law, Washington State University, USA

Eileen Peacock  
Department of Accounting and Finance, School of Business Administration, Oakland University, USA

Dasaratha V. Rama  
School of Accounting, Florida International University, Miami, USA

Kenneth Ryack  
Department of Accounting and Information Systems, University of Massachusetts, USA

Arlene Savage  
Department of Accounting and Finance, Oakland University, USA

Joann R. Segovia  
Department of Accounting, University of North Dakota, USA

L. Murphy Smith  
Department of Accounting, Texas A&M University, USA

Jay C. Thibodeau  
Department of Accountancy, Bentley College, USA

John M. Thornton  
School of Accounting, Information Systems and Business Law, Washington State University, Tri-Cities, USA

Howard Turetsky  
Department of Accounting and Finance, San Jose State University, USA

Joan Van Hise  
Charles F. Dolan School of Business, Fairfield University, USA

Gerald Weinstein  
Department of Accountancy, John Carroll University, USA

Lourdes F. White  
Department of Accounting, Merrick School of Business, University of Baltimore, USA

Thomas C. Wooten  
Massey School of Business, Belmont University, USA
EDITORIAL BOARD

Mohammad J. Abdolmohammadi
Bentley College

Joseph H. Anthony
Michigan State University

Richard E. Baker
Northern Illinois University

Bruce H. Biskin
American Institute of CPAs

Frank A. Buckless
North Carolina State University

Thomas Calderon
University of Akron

Anthony Catanach
Villanova University

Alan A. Cherry
Loyola Marymount University

James W. Deitrick
University of Texas – Austin

Bruce Dehning
University of New Hampshire

Mary S. Doucet
California State University – Bakersfield

Michael T. Dugan
University of Alabama

Thomas P. Edmonds
University of Alabama – Birmingham

Terry J. Engle
University of South Florida

Carol Fischer
St. Bonaventure University

Michael J. Fischer
St. Bonaventure University

Timothy J. Fogarty
Case Western Reserve University

Taylor W. Foster III
New Mexico State University

Mary Anne Gaffney
Temple University

Marshall A. Geiger
University of Richmond

Michael H. Granof
University of Texas – Austin

Julie Hertenstein
Northeastern University

Joe Ben Hoyle
University of Richmond

Mohamed E. A. Hussein
University of Connecticut
James P. Jennings  
*St. Louis University*

Julia Karcher  
*University of Louisville*

Thomas E. King  
*Southern Illinois University – Edwardsville*

Carol F. Venable  
*San Diego State University*

Ralph E. Viator  
*Texas Tech University*

David Williams  
*The Ohio State University*

James M. Kurtenbach  
*Iowa State University*

Linda M. Lovata  
*Southern Illinois University – Carbondale*

Susan A. Lynn  
*University of Baltimore*

James J. Maroney  
*Northeastern University*

Maureen Mascha  
*Elmhurst College*

James R. Martin  
*University of South Florida*

Steven M. Mintz  
*Claremont McKenna College*

Mark Mitschow  
*SUNY-Genesee*

Gale E. Newell  
*Western Michigan University*

Philip R. Olds  
*Virginia Commonwealth University*

Richard L. Ott  
*Kansas State University*

Sue P. Ravenscroft  
*Iowa State University*

Jane L. Reimers  
*Florida State University*

Alan Reinstein  
*Wayne State University*

Robin W. Roberts  
*University of Central Florida*

Linda V. Ruchala  
*University of Nebraska*

Timothy J. Rupert  
*Northeastern University*

David Ryan  
*Temple University*

Georgia Saemann  
*University of Wisconsin – Milwaukee*

Michael S. Schadewald  
*University of Wisconsin – Milwaukee*

Richard G. Schroeder  
*University of North Carolina Charlotte*

Barbara W. Scofield  
*University of Texas-Permian Basin*

John Sennetti  
*Nova University*

Michael K. Shaub  
*St. Mary’s University*

L. Murphy Smith  
*Texas A&M University*

Donald E. Wygal  
*Rider University*

Marilyn T. Zarzeski  
*University of Mississippi*

Douglas Ziegenfuss  
*Old Dominion University*
COOKING THE BOOKS OR MANAGING EARNINGS: STUDENTS DRAW THE LINE

Lourdes F. White

ABSTRACT

This paper describes a classroom exercise designed to determine the criteria students use to judge potentially unethical earnings management practices and to encourage self-reflection on those criteria. In phase one of the exercise, the instructor asks students to complete a survey containing scenarios of questionable earnings management practices. Based on the student responses, the instructor determines whether the students use criteria such as materiality, timing, type and purpose of earnings management practices, consistency with GAAP, and direction of earnings manipulations when judging the extent to which the earnings management practices are ethical. In phase two, the instructor reports the survey results to the students and leads them in a "value self-confrontation" class discussion so that students weigh the criteria they actually used against the criteria they think should be used for ethical judgments. This paper also reports the students’ reactions to this exercise and concludes with a discussion of the role accounting faculty and managers can play in developing capacity for moral reasoning both in the classroom and in the workplace.
INTRODUCTION

Most students will face ethical dilemmas at work. As managers, for example, they may receive pressure from a boss or a peer to compromise their personal integrity or good professional judgment by reporting misleading results. In some situations, their technical training in accounting will help them identify when an operating procedure or a reporting method clearly violates generally accepted accounting principles (GAAP). In other situations, they will feel uneasy about taking certain actions even in conformity with GAAP. The pressure to "cook the books" is intense at times, and the many gray areas of accounting leave much room for managers and accountants to exercise judgment about what to report, how to present the information, when, and to whom. How will they decide what is ethical or not? That is, what criteria will they follow (either consciously or unconsciously) to figure out where to draw the line between ethical and unethical choices?

Past research comparing ethical reasoning of business students and experienced managers has shown that students often rely only on personal reflection and individual values when trying to solve ethical conflicts (Bardarson & Webb, 1995). These studies have characterized students as "self-reliant seekers" (Lewis, 1989), who believe that they can solve their own ethical dilemmas with no help from corporate credos, company norms, or advice from senior executives. How much help, then, can faculty offer these students?

This paper reports on a classroom exercise I developed to help students grow in their capacity for ethical reasoning. I review the relevant literature in the second section. The third section of this paper describes the learning objectives and the general design of the exercise. The fourth and fifth sections discuss the two phases of the exercise: survey and value self-confrontation. The sixth section shows an example of implementation of this exercise and reports on student responses to both phases of the exercise. The last section summarizes the findings and examines how accounting professors and managers can use this exercise to improve ethical reasoning in the classroom as well as in the workplace.

LITERATURE REVIEW

Accounting Ethics Education

In the 1980s and 1990s many accounting and business programs across the U.S. increased coverage of ethical issues in their curricula, in response to calls from influential groups such as the Bedford Committee of the American Accounting Association (1986), the National Commission on Fraudulent Financial Reporting (Treadway Commission, 1987) and the then Big Eight accounting firms (Arthur Andersen et al., 1989). The recent accounting scandals involving prominent firms such as Arthur Andersen have added more pressure for accounting faculty to incorporate ethics into the accounting curriculum (Johnson, 2002). Current standards for accreditation of business school programs also call for coverage of ethical issues (AACSB – The International Association for Management Education, 2000).

While some accounting educators have increased ethics instruction in their courses, others have identified several obstacles to ethics education in business schools (detailed discussions of those obstacles appear in Cohen & Pani, 1989; Huss & Patterson, 1993). Even those who acknowledge the importance of ethics training recognize that the accounting curriculum is already so packed that coverage of ethics means sacrificing coverage of technical content essential to practice (McNair & Milam, 1993).

As the debate has evolved from whether to teach ethics to how to incorporate ethics into accounting education, empirical evidence from longitudinal tests of the effectiveness of ethics coverage in accounting is still mixed (e.g. Douglas & Schwartz, 1998), suggesting that the specific design of how instructors cover ethics significantly influences the outcomes. Different studies have argued for the use of cases (e.g. May, 1992), cooperative learning (Peek, Peek & Horras, 1994), examples of accounting heroes (Knapp, Louwers & Weber, 1998), guest speakers (Loeb, 1990), internships (Sisay, 1997), role playing (Beets, 1993), stakeholder analysis (Langenderfer & Rockness, 1989), value self-confrontation (Grube, Mayton & Ball-Rokeach, 1994) and videos (American Accounting Association and Arthur Andersen, 1989).

While the debate continues about the extent to which ethics can be taught and how to best teach it, one thing seems clear: students need to learn, preferably before they face a major ethical conflict at work, how to use their technical skills in combination with their capacity for moral reasoning to make effective business decisions. If students can benefit from reflecting on how they decide what is ethical, then faculty can help them develop their skills for evaluating ethical situations without indoctrination (Huss & Patterson, 1993). The use of ethics surveys describing managers engaging in potentially unacceptable earnings management practices offers students concrete situations in which they can apply, test, and evaluate their own criteria for judging such practices.

Surveys of Earnings Management Practices

The survey instrument used in the exercise reported in this paper has been employed in several studies of earnings management practices. Bruns and Merchant (1990)
used it with a reader sample of 649 managers who responded when this survey questionnaire was first published in the Harvard Business Review (March–April 1989, pp. 220–221). Their results revealed that the managers judged earnings management practices based solely on accounting manipulations more harshly than practices based on operating decisions aimed at achieving particular targets. Their sampled managers also rated practices that increase earnings as worse than those that decrease earnings, large manipulations as less acceptable than small ones, and year-end deceptions as more unethical than quarter-end ones.

Merchant and Rockness (1994) later used the same survey instrument with a sample of 200 general and financial managers from two corporations and 108 members from one chapter of the Institute of Internal Auditors. Their results were generally similar to the ones in Bruns and Merchant (1990). An exception was the finding that the direction of the earnings manipulation (i.e., whether it is intended to increase or decrease earnings) did not seem to influence the managers’ judgments. In addition, their sample managers concluded that manipulations for “selfish” purposes are more unethical than ones for “legitimate” purposes. Also, conformity with GAAP was not a criterion the managers used when making ethical judgments.

Fischer and Rosenzweig (1995) adapted Bruns and Merchant’s questionnaire and modified the response scales to focus on the relative ethics acceptability of operating decisions compared to accounting-based manipulations. Their sample included three groups of respondents: 122 undergraduate students, 113 MBA students, and 265 members of the Institute of Management Accountants. Similar to Bruns and Merchant (1990) and Merchant and Rockness (1994), all three groups of respondents in Fischer and Rosenzweig’s sample rated accounting smoothing more harshly than operating games. All three groups found operating games, especially those related to changes in timing of revenue recognition, ethical or, at most, questionable. The two groups of students in Fischer and Rosenzweig’s sample were more lenient towards accepting accounting-based manipulations than the IMA members in that same study. The MBA students were generally more tolerant of accounting method manipulations than their undergraduate accounting counterparts, but less tolerant than the accounting undergraduate students when accounting smoothing was accomplished by changes in inventory valuations.

THE DESIGN OF THE EXERCISE

Learning Objectives

I developed the classroom exercise described in this paper to help students achieve two main learning objectives:

1. To discover what criteria they use to evaluate potentially unethical earnings management practices; and
2. To evaluate the criteria they are using to solve ethical dilemmas in practical situations, to decide which criteria they would like to emphasize or change.

The first learning objective mentioned above relates to three goals identified by Loeb (1988) for accounting ethics education: “relate accounting education to moral issues; recognize issues in accounting that have ethical implications; and learn to deal with the uncertainties of the accounting profession.” (p. 322)

The second learning objective mentioned above relates to four other goals identified by Loeb (1988) for accounting ethics education: “develop a sense of moral obligation or responsibility; develop the abilities needed to deal with ethical conflicts or dilemmas; set the stage for a change in ethical behavior; appreciate and understand the history and composition of all aspects of accounting ethics and their relationship to the general field of ethics.” (p. 322)

The objectives of this exercise are set in motion using a combination of teaching approaches, integrated in two phases. In phase one the students fill out a survey instrument containing “mini” or scenarios, used to elicit the criteria by which they actually judge earnings management practices to achieve the first learning objective. In phase two the students participate in a “value self-confrontation” classroom discussion about which criteria they thought should be used to distinguish acceptable earnings management practices from unethical ones to achieve the second learning objective.

Fit with Accounting Courses

I have used this exercise in required graduate and undergraduate managerial accounting courses at a mid-sized state university. To integrate the ethics exercise with the rest of the course, I introduce the students to ethical issues related to managerial accounting topics such as discretionary costs, target setting in the budgeting process, performance measurement and incentive compensation, so that they become prepared to appreciate the decision-making context of ethical dilemmas in accounting. Other instructors may also use this exercise in accounting courses such as auditing, financial management, or accounting ethics courses. An important requirement is that they give systematic attention to ethical issues throughout the course to communicate to students that ethics is not a separate topic that they discuss only in the last few weeks of the term.
Two weeks before the end of the term, I distribute the survey instrument in class and ask the students to fill out the questionnaires at home and bring them to class the following week. Participation can be anonymous and voluntary; it particularly should have no bearing on course grades. The following week, I collect the questionnaires, tabulate the answers and analyze them in comparison to answers from other groups who have also responded to this survey. In the last week of the course, I report the survey results and lead the students in the value self-confrontation phase of the exercise.

PHASE ONE: THE SURVEY

Survey Instrument

The survey consists of a questionnaire originally developed by Merchant (1989) and later modified and used by Bruns and Merchant (1990). The questionnaire contains 13 brief cases or scenarios in which managers decided to take legal but questionable actions to improve short-term results. The scenarios are directly relevant to managerial accounting courses but may also apply to other accounting courses, as mentioned above. Another advantage is that the earnings management practices described in the scenarios are fairly realistic, with no clear-cut answers. The complete questionnaire appears in the Appendix. The students are asked to rank each scenario according to the following scale:

1. Ethical practice.
2. Questionable practice. I would not say anything to the manager, but it makes me uncomfortable.
3. Minor infraction. The manager should be warned not to do it again.
4. Serious infraction. The manager should be severely reprimanded.
5. Totally unethical. The manager should be fired.

The survey instrument includes no controls for the effects of gender, age or academic major, despite evidence that those factors influence ethical judgments (Borkowski & Ugras, 1992; Cohen, Pant & Sharp, 1998). The absence of those questions helps to maintain anonymity. In smaller class sections of 10 or 15 students it would be fairly easy to identify the respondents based only on their responses to these demographic questions. However, if an instructor wishes to investigate which factors explain individual attitudes about earnings management, the instructor should include questions on demographic variables such as gender, age, major, or type of work experience, which can be tested as potential explanatory factors. These questions, if added, will, of course, reduce anonymity.

Survey Administration

I have chosen to keep student participation in the survey anonymous and voluntary. Therefore students complete the surveys outside of class and return them the following week. Anonymous and voluntary participation may reduce social-desirability bias, but non-response bias may affect the results and significantly diminish the benefit of phase two of the exercise because of those students who do not participate in phase one. Alternatively, the instructor may require that all students fill in the surveys in class and collect them right away.

To allow comparison of individual answers with class responses, the instructor may distribute two copies of the questionnaire to the students and ask them to keep one copy with their own answers that they can refer to during the class discussion the following week. This will likely increase the personal benefit to the students who participate in the value self-confrontation discussions.

The timing of the survey and of the class discussion is a major consideration. When the survey and class discussions occur in the last two weeks of the course, students may perceive potential benefit from pleasing the instructor with their ethical judgments so as to obtain higher grades in the course, even though performance in this exercise is not graded. To avoid this potential social desirability bias, an instructor may choose to administer the survey during the first half of the course. Scheduling the survey earlier in the course also reduces the chances that the students will respond according to the instructor’s own ethical judgments about accounting practices discussed during the course. Administering the survey too early in the course, however, may not allow sufficient time for coverage of the accounting issues included in the survey scenarios.

Alternatively, the instructor may collect survey responses at both the beginning and end of the course to assess whether the students’ criteria for ethical judgments changed during the course. Furthermore, the survey instrument may be used at the beginning of the first accounting course, at the end of a course where these issues are specifically discussed, and some period after graduation, to measure any changes in values or attitudes of participating students and alumni. Instructors may compare these changes with evidence from prior research on the ethical development of students and alumni (e.g. Douglas & Schwartz, 1998; Fonemon & Glazer, 1990). This approach to teaching ethics in accounting courses may lead to fruitful research on the longitudinal effects of ethics instruction for business students.
Criteria for Evaluating Earnings Management Practices

After collecting the completed questionnaires, I compile the ratings for the scenarios into six pairs of contrasting types of earnings management practices to evaluate which criteria influence the students' ethical judgments. I compute average responses for all scenarios of a certain type, then for all scenarios of the contrasting types. A t-test for differences in means reveals if the average rating for one type of earnings management practice is statistically different from the average rating for the contrasting type. A significant difference in ethical ratings suggests that students are using that criterion to decide about potentially unethical situations. Six criteria that students may use to rate earnings management scenarios in the survey are presented in Table 1 and explained below.

Criterion No. 1: Accounting Smoothing versus Operating Games

Atkinson, Banker, Kaplan and Young's Management Accounting (1997) distinguishes "smoothing" from "gaming." The authors define smoothing as a practice of using accounting methods to manipulate reported results without changing actual operating actions. In contrast, they define gaming as a practice of changing operating actions to affect a performance indicator. While both types of practices may be legal (as opposed to data falsification, which is clearly illegal), they may not be ethical in certain situations. Accounting smoothing may violate the long-term goal of preserving the reliability and integrity of accounting information for the sake of short-term targets. Gaming does not require a change in accounting methods but implies that managers will actually make operating decisions that alter the timing and amount of transactions to influence reported results.

The scenarios in the survey contain seven examples of accounting smoothing and six of operating games.

Table 1. Criteria for Evaluating Earnings Management Practices

<table>
<thead>
<tr>
<th>Types of Practices</th>
<th>Scenarios*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting smoothing vs. Operating games</td>
<td>3a, 5a, 5b, 6a, 6b, 7a, 7b vs. 1, 2a, 2b, 4a, 4b, 4c</td>
</tr>
<tr>
<td>GAAP practices vs. Non-GAAP practices</td>
<td>5a, 6a, 6b vs. 3, 5a, 7a, 7b</td>
</tr>
<tr>
<td>Practices that increase earnings vs. Practices that decrease earnings</td>
<td>2a, 2b, 3, 4a, 4b, 4c, 6a, 6b, 7a, 7b vs. 1, 5a, 5b</td>
</tr>
<tr>
<td>Immaterial (small) manipulations vs. Material (large) manipulations</td>
<td>7a vs. 7b</td>
</tr>
<tr>
<td>Quarter-end timing vs. Year-end timing</td>
<td>2a vs. 2b</td>
</tr>
<tr>
<td>Legitimate purpose vs. Selfish purpose</td>
<td>6a vs. 6b</td>
</tr>
</tbody>
</table>

*All scenarios appear in the survey questionnaire included in the Appendix.

Criterion No. 2: GAAP versus Non-GAAP Practices

Much of the training accountants receive in college and early in their careers is intended to increase their knowledge and understanding of GAAP. Other business majors are also required to take accounting classes that expose them to the importance of following GAAP in financial reporting. However, it is not clear whether consistency with GAAP is a relevant criterion to evaluate whether a certain practice is ethical. Gray areas within GAAP may allow a manager enough discretion to manipulate earnings in unethical ways. Practicing accountants and managers may act unethically and still be in accordance with GAAP, or they may act ethically while departing from GAAP. Consistency with GAAP, therefore, does not substitute for ethical judgment. As Ketz and Miller argued, "Accounting is not a game and generally accepted accounting principles and ethical rules should not be construed as rules to a game." (Ketz & Miller, 1997, p. 49).

The seven scenarios in the survey related to accounting smoothing include three scenarios that are consistent with GAAP and four that are not.

Criterion No. 3: Practices that Increase versus Decrease Earnings

Conservatism in financial reporting is an accounting principle that is often a topic in the very first accounting course business students take. Students learn to evaluate inventories, for example, at cost or at market, whichever is lower. But is conservatism a criterion for ethical judgments? Some may argue that earnings management practices intended to decrease short-term earnings constitute an ethical example of conservatism. Others may argue that conservatism, while an important principle for financial reporting, is not relevant for deciding what is ethical or not. Practices that are intended to decrease earnings in one year may turn quickly into practices that increase earnings in another year, and they both serve to reinforce a culture of earnings manipulation.

The survey includes ten scenarios where managers take actions to increase short-term earnings and three scenarios where the managers decide to manipulate earnings downwards.

Criterion No. 4: Immaterial (Small) versus Material (Large) Manipulations

Materiality is another concept that is covered in most accounting courses, and is a major concern of public accountants. Auditors learn early on that certain issues are only worth investigating further if they are material, that is, if the potential benefits from fixing the problem outweigh the costs of the investigation itself. Cost accountants learn similar lessons about the materiality of variances. Materiality is also a concern in cost-benefit analysis that business students are frequently asked to perform in accounting and other business courses. Is materiality a criterion for ethical judgments?
The survey includes two scenarios that are essentially identical except for the materiality issue. In addition, the questionnaire instructions indicate that students should answer the questions as they apply to a $100-million division of a company.

**Criterion No. 5: Quarter-end Timing versus Year-end Timing**

Year-end financial results attract much attention from investors, directors on the board, analysts, regulators, and managers whose bonuses depend upon them. Quarter-end results, however, do not usually receive the same level of attention, except that they offer additional information for potential revisions of annual forecasts. A general perception is that the quality of reported earnings is higher for year-end than for quarter-end results.

In the context of an ethical dilemma, does the timing of the manipulation matter? Is a practice of manipulating quarterly earnings less unethical than a practice that occurs at year’s end?

Two scenarios in the survey are identical except for the timing issue.

**Criterion No. 6: Legitimate Purpose versus Selfish Purpose**

Business students often learn that maximizing shareholder value is the goal of the corporation. But is any practice directed at that goal legitimate or ethical? Some students who receive ethical training during their business education learn about stakeholder analysis. They learn that shareholder interests are not the only ones they need to consider, because corporate practices also affect other stakeholders (e.g., employees, customers, creditors, regulators, etc.). When the interests of different stakeholders are in conflict with each other, it may be very difficult to decide on a course of action. Are actions intended to serve shareholder interests more ethical than actions intended to serve the manager’s own interests? And how does the purpose of serving shareholders compare with the purpose of helping other stakeholders?

Two scenarios in the survey are identical except for this issue of intent or purpose: the manager’s action is exactly the same in both scenarios and only the manager’s motivation differs from one scenario to the other.

**PHASE TWO: VALUE SELF-CONFRONTATION**

Prior research on belief system theory has found support for the enduring effect of value self-confrontation on changes in values, attitudes, and behaviors. For example, Grube, Mayton and Ball-Rokeach (1994) developed a method of value self-confrontation to promote an increased concern for environmental values by psychology students. As described below, I adapted their method to encourage business students to self-evaluate their criteria for ethical decisions.

**Student Debriefing**

After I complete the statistical analysis of the survey responses and identify the criteria the students use for evaluating earnings management practices, I provide a summary in class of the survey results. I explain the way the scenarios translate into different types of earnings management practices. Then I report the numerical results (average ratings and response ranges) for the scenarios as well as the results of the tests of difference in means that reveal the criteria the students used. Examples of all these appear in the following section entitled “Example of Implementation of the Exercise.”

Students usually need about 15 minutes of silent reading to understand and interpret the results. I encourage students to volunteer “personal narratives” that would explain their criteria for ethical reasoning. If students have copies of their individual responses, this is the ideal time to invite them to compare their individual answers with the aggregate results for the class. I then ask the students to comment on any results that seem surprising to them.

Once the students have had a chance to comment on their answers, I show results from managers who have responded to the same survey to stimulate further reflection on the students’ criteria. Typically students tend to be more lenient towards accounting smoothing than managers are. I use this comparison with the manager responses to discuss the critical role accounting information plays in running a business. Some students (usually the accounting majors) may argue that the integrity of that information has to be preserved, even when under pressure from different stakeholders, and that smoothing should be regarded as a more serious infraction than gaming. I think that is the case, criteria such as the timing or direction of the manipulation and consistency with GAAP should not matter when evaluating earnings management practices, as long as the accounting numbers are telling the “truth.” Other students may argue that when managers engage in operating games the financial reports will reflect whatever actions the managers actually took.

**Normative Discussion**

At this point, when the students start to disagree, I move from a descriptive (e.g., based on personal narratives) to a normative discussion, about which criteria the students think should be used to make ethical judgments regarding business practices. Two criteria often emerge as the most controversial: purpose and materiality.
Some students argue very strongly that purpose should be the most important criterion, while others argue that the magnitude of the action itself, not the intent, is what matters. Other students maintain that materiality should not be a criterion at all, while some of their peers insist that materiality is inherent in any business decision. This type of lively interaction among students, with little need for instructor intervention, is consistent with arguments of previous research that active learning is an appropriate approach for ethics education. During this debate about purpose and materiality of business practices, it is helpful if the instructor introduces philosophical principles that not only enrich the students’ vocabulary as they articulate ethical dilemmas, but also elevate the debate to a more fruitful level. This is particularly helpful with undergraduate students who may lack the experience or maturity to appreciate the real-life implications of earnings management.

To emphasize the interdisciplinary nature of professional ethics, I have once scheduled the class session on value self-confrontation (the class discussion following the survey) to meet in an auditorium, where a philosophy professor, a finance professor and I took turns leading our combined classes on different threads of discussion on topics such as principles of moral philosophy, the rights of shareholders, and the incentives for managers to “cook the books.” This team-taught section was challenging to schedule, but it certainly engaged the students in a high-level debate, while making the best use of the complementary skills of the three instructors.

Two examples of philosophical principles I have used with my students during the class on value self-confrontation appear below. They are straightforward enough to allow accounting professors with no or little exposure to philosophy to conduct the discussion effectively without resorting to “team teaching.”

**Purpose: Rights and Duties**
The instructor may invite the students to further debate the importance of purpose of the business practice or intent of the manager by introducing Kant’s “rights and duties” principle. In ethical debates, students need to be reminded of Kant’s assertion that people should never be treated as means to an end (see summary in Beck, 1985, p. 45). If pushed to an extreme, a legitimate purpose may be used to justify unethical means. For example, the instructor may play “devil’s advocate” and ask questions such as, “If a manager manipulates earnings to help many employees keep their jobs, does the good purpose justify the manipulative action?”

While most students tend to agree that purpose should be a main criterion when evaluating a potentially unethical situation, they also recognize that it is a hard criterion to apply in practice. Purpose is especially relevant in the context of this survey, where the rating scale implies different levels of punishment for the manager involved, and purpose as a criterion points directly to the issue of the manager’s motivation to carry out certain actions. When the intent is to deceive, most students agree that the practice is not ethical. But I have found that at the end of this type of debate my students still disagreed on whether or not purpose or intent should be the only or even the most important criterion. Some are quick to dispute that too much reliance on purpose of the action leads to potentially harmful practices. Other students are uneasy about how to evaluate which purposes are good or better than other purposes. The instructor can mention ethical egoism as an example of a source of objectionable purposes.

**Materiality: Utilitarianism and Relativism**
When debating materiality, the instructor may introduce utilitarianism and relativism (Velasquez, 1988) as philosophical principles that help students appreciate the limits of materiality. Utilitarianism reasons that we should evaluate actions on the basis of how much benefit or harm they cause; ethical relativism asserts that there is no absolute “ethics;” just different viewpoints about how to define ethical behaviors.

To trigger the debate about materiality, the instructor can use probing questions such as “What is material to you? How can you tell when a business practice will have material effects?" In my experience, by the end of class, most students seem to agree that materiality should not be a criterion, for several reasons. First, earnings management practices that start small can rapidly snowball into uncontrollable manipulations. Second, materiality is a concept developed to determine when it makes economic sense to investigate a problem, but it is not relevant to the question of whether a practice is ethical or not. A similar criticism of utilitarianism emerges from this discussion. Third, materiality is a relative and somewhat subjective concept, which is applied differently depending on particular circumstances, and therefore cannot be relied upon when one is trying to solve an intense ethical conflict. This debate alerts students to the limitations of ethical relativism, as it makes ethical principles contingent on particular situations.

Accounting instructors themselves may ponder whether their own interactions with students have influenced the students’ ethical judgments. For example, the emphasis on materiality in accounting courses has the unintended consequence of students becoming more cynical about small, but potentially unethical, business practices. Habitual references to the economic consequences of business actions lead students to forget that ethical behavior often requires personal sacrifice. (For a discussion on the role of virtue ethics in accounting, see Miniz, 1995.)
Individual Differences and Group Dynamics in the Value Self-Confrontation Discussion

The main role of the instructor during the value self-confrontation discussion is not to lead the students to a consensus or to change their views. Rather, the instructor plays a facilitator role to encourage students to articulate their own values, in a class atmosphere that is respectful and rich in analysis and content. Lack of consensus is not necessarily a negative outcome, as Huss and Patterson (1993) argued. Neither faculty nor students need to convince anybody else of their views. The emphasis is on self-confrontation, that is, each student who participates in this exercise is invited to reflect on his or her own values, and to subject them to rational analysis and criticism, to evaluate which ones the student thinks should be maintained, enhanced or changed.

Given the wide range of ratings the students tend to give to each of the scenarios, the value self-confrontation discussion can also simply focus on reporting individual results on criteria used by each student. If individual criteria are available, each student can directly examine his or her own set of criteria, instead of the average criteria used by all sample students. However, this approach may compromise anonymity, and possibly introduce social desirability bias.

Any instructor who wishes to emphasize individual reflection on the student's own criteria for ethical reasoning can assign an individual paper on this topic. The student should write this after receiving his or her report on the criteria the student used when responding to the survey. The instructor may easily track individual responses without necessarily sacrificing anonymity by simply numbering the questionnaires and the corresponding reports on individual criteria. Working on such a written analysis would give the student more time to actually reflect on his or her criteria for ethical judgments (see discussion about personal narratives in Reiter & Flynn, 1999). Such an assignment should be structured so that it achieves the desired reflection. Some instructors may decide to eliminate the classroom debate altogether to downplay consensus on ethical issues and to emphasize personal reflection.

AN EXAMPLE OF IMPLEMENTATION OF THE EXERCISE

Sample Surveyed

I have implemented this exercise over five semesters in graduate and undergraduate required managerial accounting courses at a mid-size state university. Out of a total of 212 students enrolled in those courses, 141 students completed and returned their questionnaires, yielding a 67% response rate.

As indicated in Table 2, the respondents do not follow the profile of "traditional" students. The majority (72%) of the sampled students work. The respondents have nine years of work experience on average, but the actual range is from zero to 30 years of experience. About 32% of the respondents work for public companies, and 46% work for organizations with more than 300 employees. To promote anonymity, no detailed information about academic major or type of work experience is available from the respondents.

<table>
<thead>
<tr>
<th>Current work?</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>40</td>
<td>101</td>
</tr>
<tr>
<td>Number of Students</td>
<td>28</td>
<td>72</td>
</tr>
<tr>
<td>Percent</td>
<td>141</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company Public/Private?</th>
<th>Public</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>45</td>
<td>56</td>
</tr>
<tr>
<td>Number of Students</td>
<td>32</td>
<td>40</td>
</tr>
<tr>
<td>Percent</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company Employment Size</th>
<th>Yes</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>64</td>
<td>0</td>
</tr>
<tr>
<td>Number of Students</td>
<td>46</td>
<td>0</td>
</tr>
<tr>
<td>Percent</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

Survey Results

This section summarizes the responses from the sampled students to illustrate the type of analysis an instructor can perform using the scenarios discussed earlier. Since the survey questionnaire did not include questions about student gender, age, etc., one cannot extrapolate the influence that student demographic factors and course-related factors may have. Overall, the responses from this sample of students indicate a wide range of ethical judgments. Table 3 shows that the students evaluate 11 of the 13 scenarios with ratings ranging from 1 (ethical) to 5 (totally unethical); the evaluations for each of the other two scenarios range from 1 to 4.
Table 3. Average Student Ratings, Standard Deviations and Response Ranges for Each Scenario (Number of Respondents = 141).

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Average Ratings</th>
<th>Standard Deviation</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1: Accelerate scheduled maintenance</td>
<td>1.49</td>
<td>0.8</td>
<td>1-4</td>
</tr>
<tr>
<td>2a: Defer discretionary expenditures to meet quarterly target</td>
<td>2.61</td>
<td>1.03</td>
<td>1-5</td>
</tr>
<tr>
<td>2b: Defer discretionary expenditures to meet annual target</td>
<td>3.07</td>
<td>1.07</td>
<td>1-5</td>
</tr>
<tr>
<td>3: Record invoice for office supplies two months after delivery</td>
<td>3.04</td>
<td>1</td>
<td>1-5</td>
</tr>
<tr>
<td>4a: Offer liberal payment terms to boost current year sales</td>
<td>2.1</td>
<td>1.1</td>
<td>1-5</td>
</tr>
<tr>
<td>4b: Order overtime to expedite shipments at year end</td>
<td>1.76</td>
<td>0.98</td>
<td>1-4</td>
</tr>
<tr>
<td>4c: Sell excess assets at a profit</td>
<td>1.99</td>
<td>1.20</td>
<td>1-5</td>
</tr>
<tr>
<td>5a: Prepay future period expenses to record them in current year</td>
<td>2.88</td>
<td>1.69</td>
<td>1-5</td>
</tr>
<tr>
<td>5b: Increase reserve for inventory obsolescence conservatively</td>
<td>3.52</td>
<td>0.85</td>
<td>1-5</td>
</tr>
<tr>
<td>6a: Reduce inventory reserve and use it for product development</td>
<td>3.04</td>
<td>1.19</td>
<td>1-5</td>
</tr>
<tr>
<td>6b: Reduce inventory reserve and use it to achieve budget targets</td>
<td>3.29</td>
<td>1.05</td>
<td>1-5</td>
</tr>
<tr>
<td>7a: Delay $30,000 invoice of services already rendered</td>
<td>2.75</td>
<td>1.15</td>
<td>1-5</td>
</tr>
<tr>
<td>7b: Delay $500,000 invoice of services already rendered</td>
<td>3.31</td>
<td>1.20</td>
<td>1-5</td>
</tr>
</tbody>
</table>

*Ratings range from 1 = Ethical to 5 = Totally unethical.

The results in Table 4 show the scenario groupings and the average student ratings for the various types of earnings management practices. The students judge accounting smoothing more harshly than operating games. While they evaluate accounting smoothing as a minor infraction (corresponding to an average of about 3 in the five-point scale), they rate operating games simply as questionable practices (average rating of about 2). These averages are statistically different based on t-tests for differences in means at the 5% level. Given the potential effect of work experience on their ethical judgments, I compared the average ratings for all scenarios between students with little or no experience against students with more than five years of experience. The results show no impact of experience on their ethical judgments.

Based on t-tests for differences in means, the averages in Table 4 show no statistically significant difference between the ratings the students give to GAAP vs. non-GAAP practices, or between the ratings for practices that increase versus practices that decrease earnings. These insignificant differences suggest that consistency with GAAP and the direction of the earnings manipulation are not among the criteria the students use in their ethical judgments. These results remained the same even when I compared all ratings from students who work in private companies with those who work in public companies.

Materiality, timing of the manipulation, and purpose are all significant criteria for this sample of students, based on t-tests for differences in means. The students
judge the high-invoice scenario more harshly than the low-invoice one, year-end manipulations more harshly than quarter-end manipulations, and the selfish purpose more harshly than the legitimate purpose of investing in new products. To assess the influence of size on their ethical judgments, I contrasted the ratings from students who work for large companies (defined as those with more than 300 employees) to the ratings from students who work for smaller companies. The results show no impact of company size on their ethical judgments.

**The Class on Value Self-Confrontation**

In the class following the analysis of the survey results, I have started by presenting slides similar to Tables 3–5 to the students. The MBA students seem to focus on the comparison with the manager sample (see Table 5) more than the undergraduate or accounting majors do. In our class discussions I have noticed that I need to correct their tendency to refer to the managers’ responses as “right answers.”

Table 5 contrasts the average student ratings with the average ratings from managers sampled by Merchant and Rockness (1994) for each type of earnings management practice. The results in Table 5 show that the students are significantly more lenient than the managers towards accounting smoothing, GAAP and non-GAAP practices, manipulations to increase earnings, both small and large manipulations, and practices for legitimate as well as selfish purposes. The only exceptions are manipulations to decrease earnings (no significant difference between the two samples) and operating games (including both quarter-end and year-end manipulations).

During the self-confrontation part of this exercise, students are often puzzled by the reasons why they consider gaming worse than questionable, whereas the managers are more tolerant of gaming practices. One explanation that has emerged from such discussions is that as managers advance in their careers, they witness more instances of gaming and are more likely to change their attitude towards such practices (see similar evidence in Armstrong, 1987). In contrast with students, managers have been previously characterized as “organizational realists” (Lewis, 1989).

On the other hand, the students are less aware of the managers of the potentially serious effects of inaccurate financial reporting (this result is consistent with findings by Cole & Smith, 1996, using different ethical situations). The managers sampled by Merchant and Rockness, most of whom had an extensive financial background, judged smoothing and other practices to be more serious infractions than did the students.

The normative discussion of which criteria the students think should be used for ethical judgments has led to very lively debates. Undergraduate students tend to need more “lectures” to introduce philosophical principles such as rights and duties or utilitarianism. Both graduate and undergraduate students, however, seem to appreciate the importance of learning to express their positions, while respecting individual differences. I have never ended this class with a real consensus!

Student participation is noticeably less effective when a large group in the value self-confrontation class has not responded to the survey. This finding suggests that the instructor should require that the students fill out the survey questionnaires so that they can all benefit from the follow-up class discussion.

**SUMMARY AND CONCLUSIONS**

This paper reports on an exercise developed to help increase students’ awareness of the criteria they use when evaluating the degree to which certain business practices are ethical or not. The paper also reports on the survey responses from a sample of students who participated in this exercise to illustrate how instructors may use the survey to assess if their students use criteria such as type of manipulation (i.e., smoothing or gaming), materiality, timing of the manipulation, consistency with
GAAP, direction of the manipulation and purpose of the action when evaluating earnings management practices. The design of the exercise is flexible enough to meet the needs of different groups: undergraduate and graduate students, accounting and business majors, employees and managers.

The question of which criteria should be used in ethical dilemmas is an obviously complex one, transcending technical accounting issues and involving one's moral values, religious beliefs, and even philosophical orientations. This question has, in fact, interested philosophers for many centuries. The finding that this question also attracts students suggests that instructors can use it to encourage students to develop their capacity for moral reasoning.

The role of self-reflection in ethical awareness has been well documented (Esmond-Kiger & Stein, 1998; Reiter & Flynn, 1998). This increased awareness leads to an increased ability to recognize ethical issues, which precedes moral judgment (Wright, Cullinan & Bline, 1998). This type of exercise can thus benefit both students and employees at different stages of moral development (Kohlberg, 1984). In corporate training settings, for example, managers may use the survey and follow-up discussion to assess the ethical climate in their organizations, and to communicate corporate policies regarding earnings management practices.

Academics can extend the use of the ethics survey to differing types of students and managers, to report on their criteria for ethical judgments and to investigate which factors explain their responses. Cross-sectional comparisons exploring the relationships between students' criteria for decision-making in ethical dilemmas and their stage of moral development would provide further insight into how accounting faculty can help students increase their level of moral reasoning.

While more research is needed to assess how accounting faculty can actually influence ethical behavior of students and alumni, the exercise discussed in this paper serves as an example of student-directed learning about ethical issues, through personal reflection and discussions with classmates. If students have many opportunities to develop a habit of conscious ethical reasoning in the classroom, where they are away from pressure by their bosses or peers at work, then they will be better prepared to make informed decisions when they encounter an ethical dilemma at work. If they do not develop this habit, the chances are that they will not be able to think clearly when in the throes of a real ethical conflict.

ACKNOWLEDGMENTS

I wish to acknowledge a research grant from the Hoffberger Center for Professional Ethics at the University of Baltimore. Earlier versions of this paper have benefited from comments by reviewers of the Mid-Atlantic Regional Meeting and the National Meeting of the American Accounting Association, and the Annual Meeting of the Institute of Management Accountants. Ed Ketz, co-editor, and three anonymous referees of Advances in Accounting Education, as well as my colleague Carolyn Tyson contributed valuable insights for this paper.

REFERENCES


Cooking the Books or Managing Earnings


APPENDIX

Survey Questionnaire

The following questions reflect everyday ethical choices. We'd like you to evaluate the practices as they apply to a major division (annual revenues of, say, $100 million) of a billion-dollar public company. Use the following scale to indicate how you judge their acceptability.

(1) Ethical practice.
(2) Questionable practice. I would not say anything to the manager, but it makes me uncomfortable.
(3) Minor infraction. The manager should be warned not to do it again.
(4) Serious infraction. The manager should be severely reprimanded.
(5) Totally unethical. The manager should be fired.

(1) The division's headquarter building was scheduled to be painted in 1989. But since profit performance was way ahead of budget in 1988, the division general manager (GM) decided to have the work done in 1989. Amount: $150,000.

(2) The GM ordered his employees to defer all discretionary expenditures (e.g., travel, advertising, hiring, maintenance) into the next accounting period, so his division could make its budgeted profit targets. Expected amount of deferral: $150,000.

(a) The expenses were postponed from February and March until April in order to make the first quarter target.

(b) The expenses were postponed from November and December to January in order to make the annual target.

(3) On December 15, a clerk ordered $3,000 of office supplies, and the supplies were delivered on December 29. This order was a mistake because the GM had ordered that no discretionary expenses be incurred for the remainder of the fiscal year, and the supplies were not urgently needed. The company's accounting policy manual states that office supplies are to be recorded as an
expense when delivered. The GM learned what had happened, and to correct the mistake, he asked the accounting department not to record the invoice until February.

(4) In September, the GM realized the division would need strong performance in the fourth quarter to reach its budget targets.
   (a) He decided to implement a sales program offering liberal payment terms to pull some sales that would normally occur next year into the current year; customers accepting delivery in the fourth quarter would not have to pay the invoice for 120 days.
   (b) He ordered manufacturing to work overtime in December so that everything possible could be shipped by the end of the year.
   (c) He sold some excess assets and realized profit of $40,000.

(5) At the beginning of December 1987 the GM realized the division would exceed its budgeted profit target for the year.
   (a) He ordered his controller to prepay some expenses (e.g. hotel rooms, exhibit expense) for a major trade show to be held in March 1988 and to book them as 1987 expenses. Amount: $60,000.
   (b) He ordered his controller to develop the rationale for increasing the reserve for inventory obsolescence. By taking a pessimistic view of future market prospects, the controller was able to identify $700,000 worth of finished goods that conservative accounting would say should be fully reserved (i.e. written off), even though the GM was fairly confident the inventory would still be sold at a later date at close to full price.

(6) The next year, the division sold 70% of the written-off inventory, and a customer had indicated some interest in buying the rest of that inventory the following year. The GM ordered his controller to prepare the rationale for reducing the reserve for obsolescence by $210,000 (i.e. writing up the previously written-off goods to full cost). The GM's motivation for recapturing the profit was:
   (a) To be able to continue working on some important product development projects that might have been delayed due to budget constraints.
   (b) To make budgeted profit targets.

(7) In November 1988 the division was straining to meet budget. The GM called the engagement partner of a consulting firm that was doing some work for the division and asked that the firm not send an invoice until next year. The partner agreed. Estimated work done but not invoiced:
   (a) $30,000
   (b) $500,000

Some information about you:

a. What is your job title?

b. Is your company public or private?

c. Does your company employ more than 300 people?

d. How many years of work experience do you have?