

Stealth Earnings Management: Counting the Same Beans Twice?

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Existing accounting principles, auditing standards, and SEC reporting regulations offer the opportunity for managers to engage in inappropriate earnings management. Even if managers comply with all other rules, astute control over creation of a misstatement, its subsequent concealment, and eventual discovery and correction may result in positive benefits to the company. To examine the impact of such “stealth earnings management,” we identify 34 companies that published financial statements containing a misstatement, subsequently corrected the misstatement in the financial statements one year later, but made no interim announcement regarding the restatement. Results indicate that stealth earnings management may be useful in helping achieve the objectives of aggressive managers in that minimal disclosures of recounted earnings are overlooked by securities markets. Only when the auditors’ report makes mention of a restatement do securities markets consistently adjust for the recounted misstatement.

INTRODUCTION

In a study sponsored by the Financial Executives Research Foundation (FEI 2001), it was reported that the number of companies restating previously published financial statements due to an error has increased substantially since 1998. In fact, the three-year total for 1998-2000 of 464 was higher than the previous 10 years combined. While these restatements may well have been correcting unintentional errors, it is possible that managers in a subset of these companies may have been engaged in a form of earnings management.

The Panel on Audit Effectiveness (PAE 2000) notes that earnings management covers a range from “legitimate managerial activities at one end of the spectrum to fraudulent financial reporting at the other.” Legitimate managerial activities generally include discretionary choices of when to enter into transactions, thereby accelerating or deferring recognition of revenues or expenses to the betterment of the company. Other earnings management activities involve legitimate choices of how to account for transactions or other events, particularly those involving estimates or judgments.