* Advanced Financial Reporting and Regulation

**Financial Reporting and Regulation**

Question 1:

The reduced sales figures and revenue can vastly affect the image of an organization in market. In current commutative business environment none of the organizations like to see a downfall in their share prices or market reputation. So in order to manage its reputation in market and maintain the market position many organizations take the help of earning management (Schultze, 2005).

This part of the study is going to assess two different techniques that are used by companies to achieve their short term objectives by changing the actual figures. Both these techniques are “Channel Stuffing” and “Cookie Jar Accounting”. For making the in-depth understanding of concepts this report will assess a case of Bristol-Myers Squibb co (BMS). This company was levied with the penalties of USD 150 million in August 2004 for being involved in fraudulent scheme. According to Securities Exchange Commission, company inflated its sales and earnings figures to meet earnings forecasts. This study will provide the reasons behind using these techniques of extreme earning management and a critical evaluation of both these techniques.

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**A. Motivation to Earning Management Techniques**

Earning [management](https://www.dissertationfirst.co.uk/management-dissertation-topics) is the choice of accounting policies that are made by managers in order to meet some specific objectives related to reported earnings. It includes both the choice if accounting policy and real actions. The choice of accounting policy includes amortization, revenue reorganization, etc. along with optional accumulation such as warranty costs, credit losses, amounts of extraordinary items and inventory values and timing. Another way to manage earning is real actions; it includes real variables such as research and development, advertising, disposals of capital assets and purchasing timing (Stickney, Paul and James, 2004).

The different patterns of earning management are used according to economic conditions and characteristics. The taking bath pattern of earning management is commonly used when the major reorganization of company is going on. Using this pattern enhances the profitability of future reported profits because of accrual reversal. The pattern of income minimization is used for incentives in form of income tax consideration during the period of high profitability. The income maximization pattern is used for bonus purpose (Howard, 2002). Another pattern is income smoothing that is used for reducing the possibility of reporting low earnings.

Healy’s Bonus Schemes Theory: The bonus that managers will revive is the one of the biggest incentives for earnings management. It was predicted by researcher Healy in their paper “the Effect of Bonus Schemes on Accounting decisions” that the performance of managers is driven by the bonus which is given on the basis of recorded net profit. In order to maximise their bonus they are usually tempted to use any one of the patterns discussed above (Haggard, Baber, and Fairfield, 1999).

According Healy there are three situations, first of them is Bogey, it is the level of net income that is fixed by the company that needs to be reached for bonus. There is no bonus given to the managers if net income is reported below this level. The bonus to managers depends on net income above bogey. Organization also set a point where managers will get the maximum amount of bonus that point is called cap. The same amount of bonus is given to managers even if the income is more than cap.

Reduce the probability of covenant violation in debt contracts: Another motivation for earning management is to stay away from convent infringement in debt agreements of the company. These agreements indicate the limitations of company to function its business. These limitations can be in term of additional borrowing, avoiding excessive dividends, etc (Bartov, 1993).

Meeting Investor’s Expectations: Another most common motivation of earning management is to meet inventor’s earning expectations. If the expected revenue is missed by the company then its share prices goes gown but if company hits it’s expected revenue than demand of shares increases and so as reputation of the company.

According to Iron Law of Accruals Reversal all increases ultimately reverse themselves. This law states that managing the earnings upward for short term will ultimately force the future earnings downward. Thus if the management of the company manages its sales revenue greater than it actually can be for short term objectives, will ultimately result as downwards in future. So if the organization need to future postponed its reporting losses then it will require even more earning management. This law concludes that if the firm’s performance is unfortunate then the day of reckoning cannot be indefinitely postponed by earning management (Das, Zhang and Shroff, 2009).

On the basis of above study it can be stated that stuffing the channels is effective in short run but will provide loss in long run.

As like stuffing the channels, Cookie Jar Accounting is also hard to detect and so it is also an effective device of earning management. Company has some plasticity about the degree of confession of losses and gains from disposals of asset. The future earnings are deposited into bank by overprovision for losses. When these accruals reverse, separate disclosure if the effect on operating income is not required by GAAP. As to the possibility of cookie jar accounting full disclosure of non-recurring, extraordinary or unusual items may tip off an efficient market (Adkins, 2012). Hanna and Elliott (1996) documented this effect. The cookie jar accounting was being used by BMS for smooth reporting earnings.

Question 2:

Impairment loss a special nonrecurring charge which is writes down the book value which was overstated. When an asset’s book value exceeds the expected cash flow that will be received in future then asset is considered to be value-impaired. The overstated book value is reduced to fair value by an impairment write-down.

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**A. Circumstances where an impairment loss is deemed to have occurred**

When a company’s assets lose value, the impairments occur. The asset is impaired when its actual fair market value decreases less than its book value. The difference between book value and fair value is reported as impairment loss. If changes in circumstances indicate that the book value of asset is no recordable then GAAP requires investigation (Sloan and Dechow, 2001). This might happen from:

* A considerable adverse change physical condition/use of asset.
* A considerable adverse change in business climate or legal factors.
* A significant decrease in market price.
* A significant increase in cost. If the cost of construction of an asset is significantly higher than expected amount.
* When it is recognised that the disposal of asset is significantly before than its estimated life if use.
* When continuing losses projects are linked with the asset.

**B. The effect of decisions on the firm**

An analysis of the difference between the economic value based on future discounted cash flow of its consolidated equity and value in balance sheet was conducted by PSA Peugeot Citroen as part of the closing process for 2012. At 31st December 2012 this difference leads to depreciations of €3,888 million for the group. There was no effect made by these depreciations on operational free cash flow targets of the group but impacted the PSA Peugeot Citroën's net Income Group share in 2012.

The effects of such decisions on financial statement of the company are as below:

* The past income statement of the company are not repeated. The impairment loss will be included in income before tax from continuing operations in current income statement and the net income will also be poorer (Stubben, 2009).
* By the impairment, long term assets will be reduced on the balance sheet. Due to the included impairment loss in the income statement the stockholders' equity will be reduced
* The fixed asset turnover will increased for current and future lower fixed assets.

This above discussion stated that an asset is said to be impaired when its future undiscounted cash flow is lower than net carrying value. If once it is found that asset cannot recover its net carrying amount it should be recognised for impairment write down. If the impairment is recognised once than it cannot be restored. The asset impatient occur when its usage rate declines, technology changes or business and regulation climate changes. The asset can be classify as assert for sale after once determined as impaired. If company keeps on using this asset then it will be written down.