MISSISSIPPI STATE UNIVERSITY MERIDIAN

Applying Accounting Academic Research to a Real-World Accounting Enforcement Action in Intermediate Accounting

Dr. Joseph Faello, Associate Professor of Accounting
Mississippi State University, Meridian Campus

Abstract

Accounting academics have researched income smoothing extensively but rarely apply their findings in the classroom. This effective learning strategy applies the findings of 2 academic papers to a company cited for accounting infractions by the SEC. Specifically, General Electric Company (GE) engaged in 4 sanctioned activities resulting in “smoother reported earnings” during 2002 and 2003 as described in Accounting and Auditing Enforcement Release No. 3029. The first research paper by Eckel (1981) describes the statistic to identify income smoothing firms. The statistic focuses on the variability between changes in sales and earnings. Also, earnings variability is examined by comparing standard deviations of GE’s originally stated and restated earnings. The second research paper by Graham et al. (2005) surveys executives to get their opinions on the factors that influence financial reporting including income smoothing. Students apply this knowledge over a series of 7 tasks: students read the academic papers, read Release 3029, gather the financial data from the SEC database, calculate the income smoothing statistic, compare the earnings variability between the original and restated figures, and prepare a final report.
Key Words: Income Smoothing; Earnings Management; Accounting Ethics

GE Reported vs. Restated Earnings from 2001 to 2005					
in millions $					
	2005	**2004**	**2003**	**2002**	**2001**
	(Original)	(Original)	(Original)	(Original)	(Original)
Net earnings	$ 16,353	$ 16,593	$ 15,002	$ 14,118	$ 13,684
in millions $	**2005**	**2004**	**2003**	**2002**	**2001**
	(Restated)	(Restated)	(Restated)	(Restated)	(Restated)
Net earnings	$ 16,711	$ 17,160	$ 15,561	$ 12,998	$ 13,463
Variance of Net Earnings as Reported (2001 to 2005)	1,353,108				
Std. Dev. of Net Earnings as Reported (2001 to 2005)	1,163.23				
Variance of Net Earnings as Restated (2001 to 2005)	2,823,745				
Std. Dev. of Net Earnings as Restated (2001 to 2005)	1,680.40				

Conclusion:
The restated net earnings displays greater earnings variability over the period of restatement. GE's accounting choices resulted in less earnings variability and greater income smoothing in its originally reported net earnings.

Assignment Details (7 Tasks):

Task 1: Read the Eckel (1981) paper. Answer questions.
Tasks 2 & 3: Read the Graham et al. (2005) paper. Answer questions.
Task 4: Read AAER No. 3029, complaint against GE. Answer questions.
Tasks 5 & 6: Calculate Eckel income smoothing statistic and variability of earnings.
Task 7: Write up final report.