Question 4

* Earnings Management refers to the strategy used by the management of a company to deliberately manipulate the company’s earnings so that the figures match a pre-determined target and is carried out for the purpose of incoming smoothing (stable figures rather than high losses in one year and high gains in another)
* Cash-based accounting: R and E are recorded only when cash exchanges hand
* Accrual-based accounting: R and E when earned and incurred
* If CBA was used instead of ABA, accountants will be limited in their ability to record R and E (as cash is immediate and unadjustable, for example, companies can record certain revenues as unearned for the next accounting period, making it seem like there are high gains to be made) and therefore earnings management is reduced
* CBA does not provide a comprehensive understanding of a periods performance because it postpones or accelerates the recognition of R and E
* CBA neglects receivable and payable accounts and therefore will not report certain revenues and expenses (may show a loss when entity is actually making a gain and vice versa)
* In essence, CBA reduces earnings management as it limits the amount of R and E that can be recorded and used to manipulate the profit figures of a business
* If cash flows from operations equals profits for a business and accounting transactions are unadjusted at the end of the accounting period, many of the business R and E will be deferred into an inappropriate accounting period which may potentially be misleading.
* Adjusting entries are crucial in obtaining accurate measurements of profit or loss
* It is essential to record adjustments in order to ensure R and E are properly recorded in the correct time frame
* ABA more accurately reflects the financial positions of a business as it records R and E using the matching principle, when they effect the business
* Although ABA allows and is flexible with earnings management, the rigidity of CBA will understate or overstate a company’s R and E