Earnings management

Berkshire letters: 1998, 1992, 2000 · Difficulty: Intermediate

> *"The distortion du jour is the "restructuring charge," an accounting entry that ... too often is a device for manipulating earnings." (1998)*

1. A company books an unusually large restructuring charge in a bad year (a "big bath"). What does this most likely do to the following years' reported earnings?

   A. Has no effect

   B. Eliminates all future expenses

   C. Makes them look better, because future costs were charged early

   D. Makes them look worse

2. Buffett writes, "We prefer a lumpy 15% return to a smooth 12%." Why should an auditor be skeptical of very smooth earnings?

   A. Smooth earnings are illegal under GAAP

   B. Auditors cannot audit smooth earnings

   C. Smooth earnings mean no taxes are paid

   D. Smoothness can come from adjusting estimates and reserves rather than from the business

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1998, 1992, 2000 (berkshirehathaway.com/letters). Quotation © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. Numbers in the questions are made up unless stated.