Managing the business 'quality' way

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Abstract

It is said that, 'Profit is the lifeblood of business.' In this cut-throat competition, therefore it is more about managing the business profitable way. The very importance of ethics and values, i.e. quality gets lost in this endless race. This gives rise to earnings manipulation by the corporate. The present paper discuses the earnings management behavior of the corporate and draws out attention to the short-sightedness of the poor quality corporate earnings. 'Earnings management' is a management practice to manipulate the earnings for specific motives.

1. Introduction

A successful business does not just make profits; it earns every penny of profit with its behavior and the way it works. According to the legendary Einstein of quality and business, Dr. W. Edwards Deming (1900-1993), all businesses are really in one business only. Regardless of what business you are in - service, manufacturing, education, non-profit, etc. - there is one primary aim that you must be acutely aware of and continuously strive to master if you wish to grow and prosper. If you don't focus and master this critical success factor, your days may be numbered; at the very least, you will likely be doomed to mediocrity. Here, lies the significance of ethical way of doing business.

"Quality Profits should be the mantra of managing the business" and it is the law of the nature that only quality organizations last. Throughout human life, it is always right which prevails over wrong. Business organizations equally need to conduct proper behaviours. This is what is defined as "the discipline of identifying what is good and bad and pursuing the right with moral duty and obligation. Lev (1989) popularized the adjective "quality" in regard to earnings by stating that stated that there is no serious attempt made to question the quality of the reported earnings.

Business houses are more powerful, strong wealth creators and great influence –makers in today's world, but these results in misuse of power. Global meltdown of 2008 is the evident reality of the fact which has raised the same question once again – How to manage business? It is an ever going debate between quality vs. profits. So, there's a clear social need to investigate and influence the ethical foundations of management behaviour of corporate.

'Quality' refers to ethical behavior on the part of corporate.

2. The Quality in Business!

Either it's Enron, WorldCom or Satyam in the past or recent case of Sahara in India, the commonality is the lack of ethical behavior on the part of the management. This is what is described as poor quality of earnings. "Quality business" implies right profits which are

sustainable in the long run. But, this quality aspect is often overpowered by the management's discretionary behavior to manipulate earnings.

"Earnings management occurs when managers use judgment in financial reporting and structuring transactions to alter financial report to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." Healy and Wahlen (1998).

There are varieties of reasons which are put forth for the discretionary behavior of the management, like market pressures, lending agreements, performance incentives or personal motivations. Watts and Zimmerman (1978) analyzed discretionary earnings behaviour of the management for influencing contractual outcomes. DeFond and Jiambalvo (1994) find that firms increase earnings prior to lending covenants, Dechow and Sloan (1995) found that CEOs reduce R&D expenses in their final years of service, in order to show high earnings. Teoh, Welch and Wong(1998a), detected earnings management behaviour in case IPOs. Dechow and Skinner (2000) highlighted capital market incentives for earnings management. Shuto (2007) found out that discretionary accruals are positively and significantly associated with executive compensation.

3. Earnings management practices

As discussed earlier, corporate engaged in varied forms of poor quality management practices to misrepresent the financial performance of the corporations. Following are the different earnings management practices employed by the management.

i. Bogus earnings

Revenue recognition on a fictitious side is a common activity in the constantly changing competitive environment where a company is under a constant pressure to attain targets for investors. Using accounting principle of revenue recognition to the personal convenience and recording bogus sales is the extensive form of earnings management, leading to fake profits.

ii. Channel Stuffing

It is the deliberate manipulation of earnings to project a growth picture. The company bills the customer and holds materials on its behalf, and the buyer has right to return in case it does not sell. This results in low sales and declining profits in later periods. Callen, Robb, and Segal (2008) found out that firms with a string of losses overstate revenues because revenue is used as the basis for value creation by the shareholders.

iii. Cookie Jars

Corporation overestimate expenses during the current period to manage earnings and when actual expenses are lower than budgeted, the difference can be put into the "cookie jar." It can be used later when the company needs a boost in earnings to meet predictions. For example, Provision for bad debt; provision for inventory write downs; estimating warranty costs; estimating pension expense, etc. In his speech, Levitt (1998) highlighted cookie jar reserves as one of the major applications of earnings management. Earnings management through subjective accounting estimates such as reserves. Cookie-jar reserves involve both decreasing and increasing earnings (e.g., Sweeney 1994; Elliott, Nelson and Tarpley 2002).

iv. "Big Bath"

Corporations may write-down assets or change and even write off the accumulated losses in a single year, showing it into major losses and claiming tax benefits on the same. Also, the

intention is to get bail-outs from the government authorities and not to share profits with shareholders.

v. **"Big Bet" on the Future**

Acquisition of another company results in big bet to the acquirer company for the future. Under Generally Accepted Accounting Principles (GAAP) regulations, an acquisition must be reported as a purchase. The usual practice of earnings management in such a case is that company can write off continuing R&D expenses against current earnings in the acquisition year and protecting future earnings.

vi. **Capitalisation of Expenses**

The cost of development and expenses incurred on consumption of operating resources are recorded as an asset (intangible assets) or even (tangible assets) over the periods and hiking the net worth of the company.

4. Ensuring quality for business management

There are multitudes of factors which drive corporate interest in ensuring that ethical business standards are upheld. They may arise from the business environment, or societal motivations or regulatory framework and others. They not only orient the business management towards the quality way but also ensure that their quality behaviour pays them in the ultimate. AAMA/HRI's Business Ethics Survey 2005 was a step in this direction of identifying the drivers for ensuring business ethics and quality in present and in future, i.e. 10 years from today. Table 1 lists the reasons for Business Ethics.

Table 1: Top Five Reasons to Run a Business in an Ethical Manner

Factor	**Rank**
Protection of brand and reputation	**1**
The right thing to do	**2**
Customer trust and loyalty	**3**
Investor confidence	**4**
Public acceptance/recognition	**5**

Source: The *Ethical* Enterprise - American *Management* Association
http://www.amanet.org/HREthicsSurvey06.pdfAcessed on 25th July, 2013.
Following is the discussion about the relevance of quality profits.

a) *Brand building:* Business malpractices and unfair trade practices like black-marketing, artificial high pricing, adulteration, cheating in weights and measures, selling of duplicate and harmful products, hoarding, etc harm the corporate image. Quality behavior helps to build the brand of the company.

b) *Improve customers' confidence:* The consumer is the king of the market. Quality behavior improves the customers' confidence about the quality, quantity, price, etc. of the products. The customers are more loyal to the corporate that follow ethical rules.

c) *Investors' confidence:* Quality management of the corporate infuses confidence among the investors, particularly shareholders of the company. They are assured that they will not be cheated by the top and this is always helpful in the growth of the company.

d) *Survival of business*: Business quality is essential for the survival of business. The businessmen who do not follow it will have short-term success, but they will fail in the long run. Therefore, if the businessmen do not follow ethical rules, he will fail in the market. So, it is always better to follow appropriate code of conduct to survive in the market.

The World's most ethical companies are leaders of their respective industries when it comes to key ethical criteria such as tone from the top, employee well-being, compliance programs and other important areas. This strong quality culture of is also key to their increasing financial performance. Table 2 lists world's ethical companies of 2013.

Table 2: 2013 World's Most Ethical Companies
(Select list alphabetically)

Company	Industry	Country
ABB Asea Brown Boveri Ltd	electrical equipment	Switzerland
Accenture	business services	Ireland
Baptist Health South Florida	healthcare services	USA
Capgemini	business services	France
Colgate-Palmolive Company	consumer products	USA
Dun & Bradstreet	business services	USA
Kellogg Company	food and beverage	USA
Microsoft Corporation	computer software	USA
Tata Steel Ltd	metals and mining	India
Wipro Ltd	computer software	india

Source: Ethisphere, http://www.forbes.com/sites/jacquelynsmith/2013/03/06/the-worlds-most-ethical-companies-in-2013/Accessed on 2nd August, 2013.
The next key area for quality behavior stems from the business drivers as given in table 3.

Table 3: Top Five Business Drivers in Terms of Their Impact on Business Ethics

Factor	Rank	Rank in 10 years
Corporate scandals	1	4
Marketplace competition	2	2
Demands by investors	3	5
Pressure from customers	4	3
Globalization	5	1

Source: The *Ethical* Enterprise - American *Management* Association
http://www.amanet.org/HREthicsSurvey06.pdfAcessed on 25th July, 2013.

So, an insight into managers' behavior to misuse earnings and report poor quality is essential for all the market participants for better financial decision-making. The role of these drivers is very crucial for managing the business. Of lately, companies have started recognizing the value of ethical behavior by way of integration of company to manage business. These key drivers to ensure the quality way of business are discussed as follows:

a) Scandals

Enron was the first global scandal to affect the world economy at large. But it was not alone in shaking investor confidence in corporate ethics and governance. Adelphia, WorldCom, Tyco – these were some other names to reckon with in this race of corporate scandals. Bernie Ebbers, former head of WorldCom, was convicted in March 2005 for the $11-billion accounting fraud. Adelphia Communications Corp. founder John J. Rigas and his three sons forfeited $1.5 billion in assets from fraudulent activities. This how the Sarbanes-Oxley Act (SOX) in US and Clause 49 of listing agreement in India were enacted in 2000 to protect investors from unethical management practices (See Box 1). Findings suggested that these regulatory interventions did reduce the practice of earnings management

Box 1. Clause 49 & SOX

Clause 49 of the Listing Agreement of SEBI, called 'Corporate Governance', contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Report on Corporate Governance, and Compliance, respectively.

Sarbanes- Oxley Act (SOX) is complete Act on corporate governance. It covers relevant areas like '*Public Accounting Oversight Board'* to oversee the audits of the companies listed in US, R*egulation for Executive Directors and Officers* and *Auditing Quality Control.*

b) Competition

Business pressures and growing competition is another major business driver of ensuring business quality. This aspect can be attributed to fact of business life. Every single competition puts pressure on businesses to perform, and this sometimes means cutting ethical corners. Therefore, the concept of 'healthy competition' is stressed upn here for gaining business advantage in the long run.

c) Shareholders

For the ethical process to operate effectively, stakeholders' principles and best practices need to be in place. The management interest should not overpower stakeholders' interest, rather be in align of theirs. Here, the focus is particularly on shareholders' representation in management and a spirit of cohesiveness between management and them. Shareholders are a major force for change. As a result of losses on account of corporate frauds, stockholders became more active, whether through proxy resolutions aimed at curbing CEO pay (Borrus & Arndt, 2003) or by becoming more active in governance issues.

d) Consumers

Consumers are often influenced by company reputations. They pay attention to the social behavior of businesses in their nations and use reputation in deciding which products to buy and which companies to patronize. This has touched upon the ethical side of management in a larger way for doing business.

e) Globalization

Go global is the voice of today! Globalization has made world economy very small and therefore it has emerged out as the single greatest influencer on ethical behaviour of the corporate

for business management. Companies having a global touch are always looked up to by the stakeholders.

1. Conclusion

A corporate into any unethical practice is not accepted by the economy even if it a major contributor. Therefore, companies have started realizing the importance of quality and not profitability. There is no alternate to quality profits. Concept like social responsible investing and ethical investment are introduced to promote ethical culture in society. Investors also like to go with ethical firms. The government's role is also very crucial in the said context to design a proper system which can provide right atmosphere and ensure quality ay of business by the corporate.

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