

## Business management: quality vs. profits

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### Abstract

*Business proposition is based on cost-benefit trade off, i.e. Profits. Undoubtedly, business organization can not justify its existence without showing reasonable degree of profitability. But, profitability is given the prime importance at the cost of quality behavior. This is where the problems of ineffective management arise due to poor quality. The quality scale of profits shows the level of efficiency achieved by an organization in totality. The present paper is an attempt to highlight the importance of quality behavior of profits for effective business management and stressing the need for effective people management for the same.*

### 1. The Introduction

It is often said that the main objective of any business is to earn profits. Profits only take the business in the longer run. But, the problem with this profits concept is that it is short-sighted and often misused. Corporate sacrifice quality for profits and looking at the increasing trend of poor quality profits worldwide, the scene is becoming all the more alarming. "Quality should be the mantra of any business" and if business has quality, profits will eventually follow in the long run. Firms with quality profits have survived in the passing generations, not the firms with short-term profits. So, it is the 'right' which has to be predominant in profits.

### Right way of business results in better growth and stability

It is about standing tall in all times. Global meltdown of 2008 is still pinching countries with its aftereffects. European recession has added fuel to the fire. Every economy is struggling to face the emerging challenges out of this crisis. The burning question is - How to manage business in this adverse time and still grow? Here, the importance of 'quality of earnings' is being stressed upon. 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.

### 2. Quality of Earnings: 'Earnings Management'

Either it's Enron in 1990s or AIG and Satyam in 2008, they all propounded low quality of earnings. Profits are a surviving bone for a business, but quality oriented. "Quality profits" refer to sustainable profits. It is very easy to maximize profit once but impossible to continue profit unless backed by quality behaviour of the management. It is not a good long-term strategy (but one that is, unfortunately, being pursued by most of the "bottom line" show preachers).

The business ethos has undergone a “paradigm shift” in the sense that the ethical aspect of management has often been ignored. This draws our attention towards earnings management. ‘Earnings management’ is a strategy used by the management of a company to deliberately manipulate the company's earnings in order to match the pre-determined performance. “Earnings management has been considered an integral part of every top manager’s job. But when managers smooth earnings to meet market projections, they’re not creating value for the firm; they’re both lying and making poor decisions that destroy value” Jensen (2004).

Earnings management may be undertaken by entities with a view to managing impressions of the entity for number of reasons, like debt contracts, compensation agreements or equity offerings. Watts and Zimmerman (1978) analyzed discretionary earnings behaviour of the management for influencing contractual outcomes. Fudenberg and Tirole (1995) concluded that, managers indulge in earnings management for their jobs concerns. Dechow and Skinner (2000) highlighted capital market incentives for earnings management. Bergstresser and Philippon (2006) proved that the firms which have CEO compensation linked to value of stock are found to be indulged in manipulation of earnings more.

### **3. Industry practices’ discussion**

With the changing times, meeting earnings estimates has become something of a religion for corporate executives. Senior managers had their pay tied to profit performance. To avoid taking a beating, corporate managers would simply make up these numbers.

**How?** By employing a series of small bookkeeping changes within the generally accepted accounted principles! It is "earnings management." Practices employed by the management to misrepresent the true financial health of their corporations.

#### ***1. Recognizing Revenue for Out-of-Period Sales***

Today, business operations of manufacturing and services are performed in an environment where a company is under a constant pressure to attain targets for investors. This result in revenue-manipulation exercises. Earnings-management practices range from marginally extending the year-end shipping date to reporting fictitious sales. Playing with the computer system date beyond Dec. 31 is the mildest form of earnings management, leading to out-of-period sales. Studies on revenue manipulation have focused on accounting maneuvers that pull revenues forward in time (Altamuro et al. 2005, Forester 2009).

#### ***2. Channel Stuffing***

Deliberate manipulation of earnings by the enterprise to create an appearance of controlled or disciplined growth is another common form of discretionary earnings behaviour. Sales figures can also be hiked by offering customers financial incentives – through price discounts, extended payment terms, or other concessions – to write purchase orders well before they need them (“channel stuffing.”) The defense given is investors’ preference. Investors focus more on revenues for valuing high growth firms (Ertimur, Livnat, and Martikainen 2003; Ertimur and Stubben 2005).

With channel stuffing, a company bills the customer and holds materials on its behalf, and the buyer could return the merchandise if it did not sell and require the seller to pay all

costs of shipment and storage. The outcome is erosion of profits and weaker sales in later periods. Callen, Robb, and Segal (2008) investigated that firms with a string of losses overstate revenues because investors often use revenue as the basis for valuing these firms.

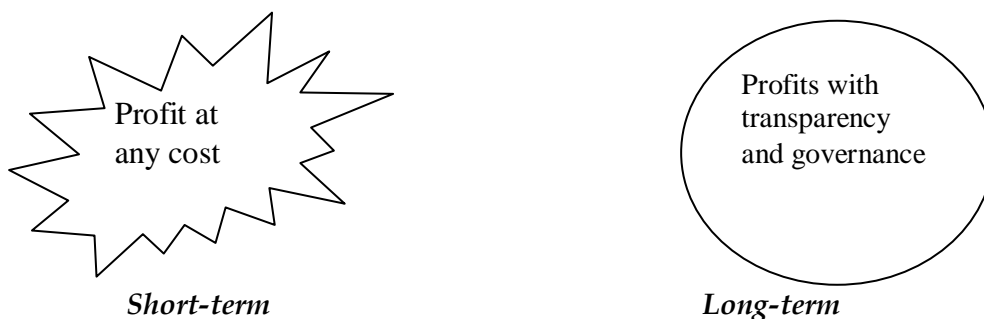
### 3. Prematurely Recognizing Revenue for Customer Contracts

Dispatching orders ahead of customer requirements is another means of inflating sales volume. In such instances, the customer may or may not accept the materials. In cases where the customer accepts the material, the customer assumes ownership of the material but is not liable for making payments until the stipulated date. If customer refuses to accept the goods, the title to the property remains with the seller and does not pass onto the buyer until the stipulated delivery date. More than half of the financial reporting frauds among U.S. public companies from 1987 to 1997 involved overstating revenue, according to a study conducted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Auditors have always focused on possible revenue recognition overstatement in financial statements (Phillips, et al. 2001).

### 4. Cookie Jars

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 and provision in the profit and loss and balance sheet is practicing cookie-jar reserves. It is ad-hoc creation or revocation of the discretionary debt reserve accounting estimate. Dhaliwal et al. (2004) provide evidence that the tax expense is used as a cookie jar to meet the analysts' forecasts. Cookie-jar reserves involve both decreasing and increasing earnings (e.g., Sweeney 1994; auditors' emphasis on income-increasing accruals as seen in Elliott, Nelson and Tarpley 2002).

So, the factor which has always been the most undermined for business management – ethical way of business! For nearly last five decades, companies have relied on sales and profit planning (S&PP) in their effort to improve business performance. The business root of ethics and good governance has gradually taken a back seat.



**Figure1: Profit shades**

*It is the law of the nature that profitable firms remain like a bubble, quality vested profitable firms grow like tree,(see above figure.)* "The Numbers Game," a much-publicized 1998 speech by Arthur Levitt, then chairman of the Securities and Exchange Commission, Levitt warned of the intense pressures on companies to meet earnings estimates. He emphasized that Business does not exist

in a vacuum. It is a part of society and it can achieve its economic objectives only by discharging responsibilities towards society. Therefore, the concept of **Fair Business Management** and **Quality Profits** are the key pillars for long run.

"[...] The life of money-making is one undertaken under compulsion, and wealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else [...]" **Aristotle, cited in: Amartya Sen**

### 3.1 How to bring quality for effective management?

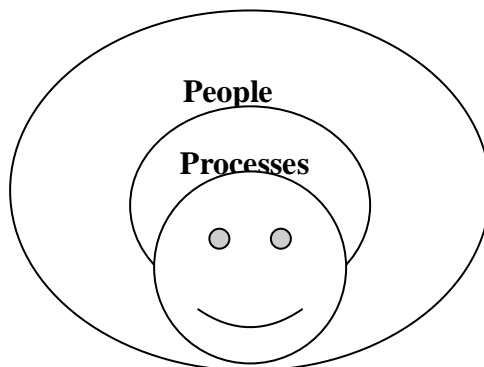
An insight into managers' behaviour to misuse earnings is essential for all the market participants for better financial decision-making. The role of people and processes in the said regard becomes very significant. They are the most important pillars of business management. Of lately, companies have started recognizing the value of ethical behaviour by way of integration of company to manage business.

#### *People and Process*

Effective business requires two primary elements to be working in concert: people and processes

People: For the 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 on stakeholders' representation, particularly shareholders, at all levels and management and a spirit of cohesiveness between management and them

Processes: It is important to operate the process with open and honest communications. They should align, integrate and synchronize the people for the betterment of business goals. It highlights accountability on the part of management towards stakeholders in the form of proper disclosures.



**Figure 2: Resources' Alignment**

People and Processes alignment leads to a smiling business with long-term quality profits (figure 2)

### 4. Conclusion

In nutshell, a business cannot survive without profits just as a human being cannot live without

food. But profits cannot be the sole goal of business just as eating is not the sole aim of life. Over the years, researchers have highlighted various essentials of “earnings quality” for effective business management representation but they have not been of decision usefulness in practice. Thus, People and process management is of high relevance for quality business management.

To quote, “Does the end justify the means?

That is possible. But what will justify the ends?

To that question, which historical thought leaves pending?

Rebellion replies: the means.” (Albert Camus,1991)

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