

Earnings Management: The Game

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Concerns over earnings management have been expressed in both the accounting literature and popular press. Forensic accountants must identify environmental variables that encourage or inhibit management dishonesty. This paper describes a game used to help students understand that information asymmetry exists between managers and the public, and that public information may be misstated to increase management wealth. The rules of the game are manipulated to illustrate how changes in the business environment can constrain earnings management and misstatements. This game has been used in the first course in our Master of Accountancy program, but it is applicable to any course addressing earnings management or fraud control.

Students are dealt cards, trying to get as close to 21 as possible with the fewest number of cards. They are asked to report a value of the cards to the public, but are allowed to bluff. A die is rolled to see if the cards must be shown. If the roll indicates the cards do not have to be revealed (the true state of nature is not observed), then students are rewarded based on their public disclosure, even if it was not the truth. If the die indicates the cards must be shown (the true state is observed) and the student lied to the public, then penalties are incurred. Several rounds are played in which the probability of observing the true state and other rules vary.

Primarily, the rules of the game are modified to reflect different environmental changes that may impact dishonest behavior when information asymmetry exists. The rounds of the game emulate issues discussed in agency theory and observed in the current accounting environment. The learning objective of the exercise is to help students see that managers will modify behavior to maximize wealth based on the incentives and constraints provided by the “rules of the game”. If there are no penalties for lying, that behavior will be more prevalent. Imposing various restrictions can reduce deceptive reporting. The game illustrates the factors that make public information more reflective of the state of nature known to management.
