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Earnings Management, Part II: Why Current Financial Reporting and Enforcement Efforts Fail

By Manuel A. Rodriguez

Current financial reporting practices often produce fictional and sometimes aberrant statements that are misleading if not outright fraudulent. For example, consolidated financial statements are traps for the unwary, hiding and masking transactions through Byzantine group structures and idiosyncratic consolidating techniques.

Consolidation procedures require that inter-group transactions be eliminated when the financial statements of the group are consolidated, on the theory that this procedure eliminates transactions between the group that are not at arm's length and which may in fact be shams. But consolidation accounting has another, less obvious yet insidious result – it purposely conceals and buries subsidiary information within the group's consolidation, hiding both the enlightening and damaging aspects of subsidiary performance within the whole.

Consolidation accounting purports to represent the economic activity of a group of legally separate and unique entities under the fictional mantra of the group, relying on economic form over legal form and financial substance. They conceal data that might normally be available to users of financial statements, and may serve to hide data from shareholders and creditors that is damaging or otherwise disparaging.

Data not found in unconsolidated financial reports mysteriously appear in consolidated statements under the guise of economic substance, yet bear little relation to real-world substance and the individual, disaggregated accounts of the subsidiary. This theory of aggregation is contrary to the norms found in GAAP – that of full disclosure and careful consideration of an entity's viability as a going concern.

Prevailing consolidation techniques ignore the legal and financial implications that the aggregated assets and liabilities are neither owned nor made available to the group. This group mentality encourages users and readers of financial statements to view the entities of the consolidated group as virtual branches of the parent, again creating a dangerous fiction rendering the financial statements less meaningful. The grandest of these fictions, though, is the assumption engendered by consolidation accounting that profits and losses of the subsidiary entities will pass through to the parent entity through dividend payments.

Current financial reporting compliance efforts have also failed to prevent audit and accounting failures. A decade-old study of corporate failures in Australia by professors F.L. Clarke, G.W. Dean and K.G. Oliver, *Corporate Collapse, Regulatory, Accounting, and Ethical Failure*, explored the notion that greater compliance with prescribed standards and zealous enforcement of those standards would achieve serviceable financial standards that were informative and models of comparability, the SEC's over-arching concern for many decades.

The authors concluded that even meticulous compliance with approved accounting standards and strict enforcement by the regulatory bodies may not produce useful financial statements: "compliance with standards then in vogue was as likely to have contributed to creative accounting as deviation from them. Perversely, corporate regulators and the accounting profession are calling for even more accounting and auditing standards."

By explicitly imposing detailed standards on the financial statements, auditors can essentially shield themselves from liability through strict adherence to GAAP's "cookbook" in defense of their accounting judgments, and avoid being held directly responsible for making those judgments. By strictly adhering to accounting standards, auditors also reduce the tendency to opinion-shop by stressing the unyielding nature and detail inherent in the standards in defense of the positions taken.

The study principally focused on the end-product of the accounting process, the financial statements, and their ability to convey data accurately, without misrepresentation and lack of comparability, as opposed to singularly focusing on the process of accounting and its methodology. "Accounting standards have failed to match the admirable claims of the leaders of the profession – namely, that compliance with them would reduce the diversity of accounting practices and thereby provide data relevant to the making of informed financial assessments," the authors add. "Defying financial common sense, complying with certain practices endorsed by the accounting profession itself, producing the standard nonsensical, fictional financial outcomes, are not regarded by either the regulators or (so it seems) the accounting profession to be a willful indulgence in creative accounting."

Control of the process by which standards are developed and applied and zealous enforcement of those standards through strenuous regulatory activity appears to be the principal mechanism to ensure the stability of the financial reporting model worldwide. These feeble attempts to eliminate judgment from financial statements, a position strikingly similar to that held by the SEC and Arthur Levitt, its former chairmen, ultimately obviates the need for serious discussion regarding the quality of the output.

Current accounting compliance efforts focus on individual misdeeds and the need for greater regulatory efforts, rather than on the serviceability of the financial reporting model as presently structured. Efforts to identify crooked individuals and their "cult of personality" have in fact diverted attention away from fundamental restructuring towards individual scapegoats and single instances of ethics failure, bad management, and inadequate educational resources.

While the trend towards increased vigilance of earnings management and zealous enforcement may sometimes deter the brazen and unscrupulous, it will not, however, prevent strict application of accounting standards to financial data, often leading to bizarre and unintended results. Thus, the failure of accounting is often the result of poorly constructed standards that have no legal or economic basis.

For instance, the constant drumbeat of substance over form fails to reveal and clarify the arcane ambiguities of consolidation accounting and historical, cost-based financial reporting. Substantial modification of the financial reporting model would involve reform of financial consolidation principles to reflect the legal and economic reality of the corporate structure. A shift to fair value accounting would also prevent the gross miscalculations of value that continue to plague analysis of corporate stability and liquidity. Indeed, fixed asset depreciation models and real property accounting are little more than cookbook applications having little economic substance.

The real issues that have created these accounting fictions have yet to be addressed by any private or governmental regulatory agency. The captains of industry, board members of the regulatory agencies, and members of the national accounting firms share the common goal of avoiding disruptive change.

The accounting industry seeks, most importantly, to avoid liability, and the cookbook standards pervasive today well accomplish that goal. Captains of industry seek to manipulate accounting data to create financial reports that present their organization in a favorable light. Regulatory agency members are often products of private industry, as many are tapped directly from the boardrooms of corporate America and

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the accounting industry; hence, they too have no incentive to seek substantive reform of our financial reporting system. Given the entrenched and unyielding regulatory and economic structures currently in place, it is difficult to see how any effective change will soon occur.

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