

Ethics in Accounting – Continuing and Increasing Challenges

Eastern Wisconsin FEI

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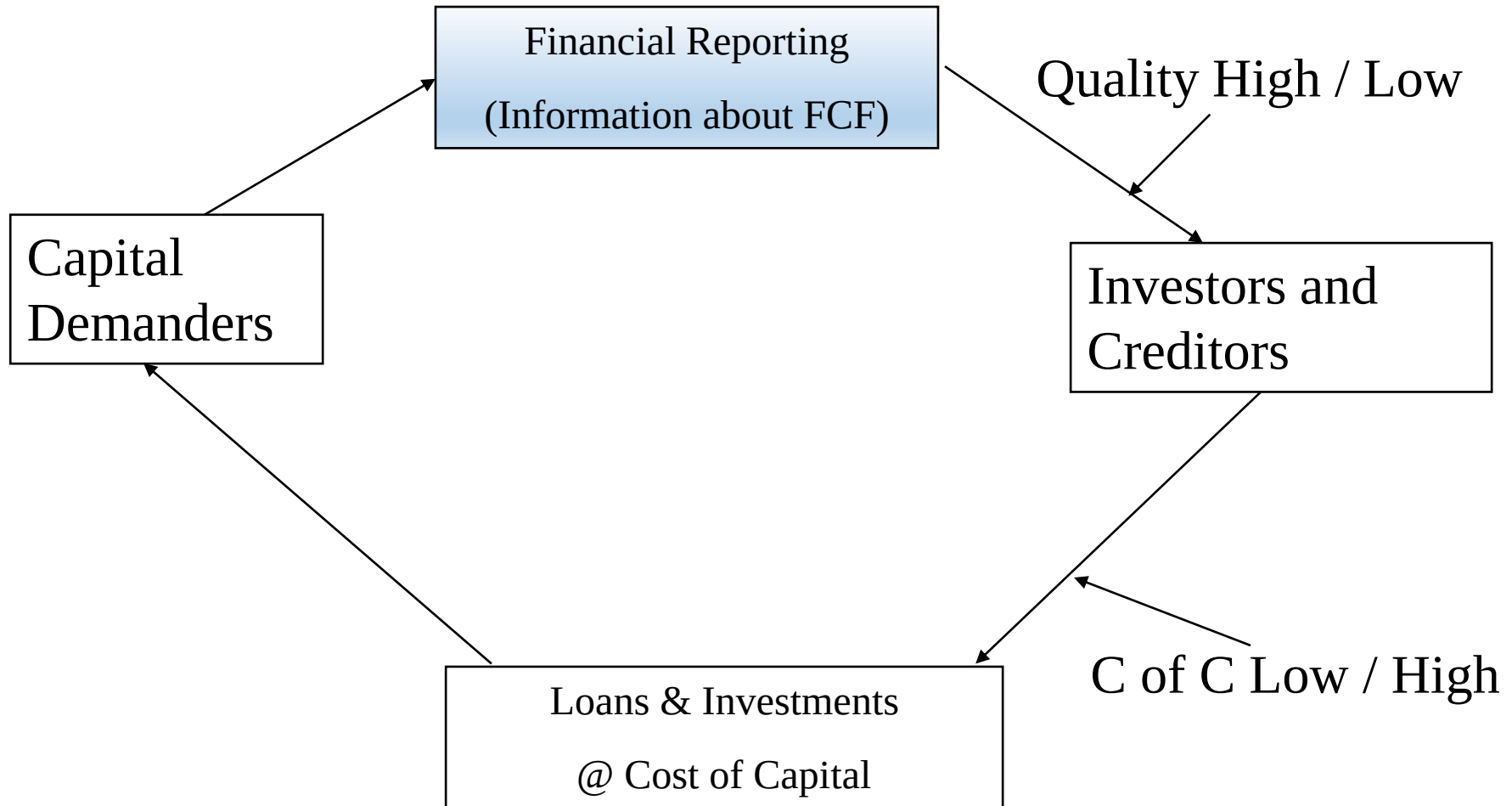
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Accounting Transparency or Managing Accounting Risk

- Accounting in Action
 - Financial Reporting Framework
 - What makes accounting reports useful – the role of judgment.
 - FSQ Case – Judgment²
 - Accounting Quality Factors – Increased judgment is here to stay.
 - Accounting Risk – How do companies drive ethical accounting judgments that lead to higher quality reporting, leading to lower cost of capital.

Financial Reporting Quality



Financial Reporting Framework

- Accounting Information as a commodity.
- Costs and Consequences of a quality information product – for markets and firms.
- How to improve quality -- Role of ethical accounting judgments.



Demand for Financial Reporting

- Why do companies prepare financial reports?
 - Analogy to used car market...
 - Salesperson knows more about the true value of the car than you do.
 - Classic case of information asymmetry, which can increase the cost of transactions in the market... costly actions by both parties:
 - Buyer... get more information
 - test drive
 - get your mechanic to look at it.
 - discount price willing to pay for the car.
 - Seller
 - offer a warranty
 - provide more information about the car



Extend to Financial Reporting

- Analogy to the market for capital.
 - When companies sell stock or borrow money, they also are asking investors and creditors to “buy” something (the prospective cash flows of the company), about which the company has more information than the outsiders.
- That is, one group of stakeholders can benefit at the expense of others, using better information:
 - managers/insiders versus
creditors/prospective shareholders.



Extend to Financial Reporting

- Expected response to this information asymmetry... similar to the used car market (market for lemons):
 - Investors / Creditors demand an “information premium” to provide capital.
 - Company has incentive to reduce this information asymmetry and avoid the cost of the “information premium”.

This is the role that financial statements and financial reporting play in our economy.

Financial Reporting Regulation

- Why needed?

Although companies have incentives to voluntarily provide information to investors and creditors, they may not voluntarily provide full disclosure. If unable to capture the benefits from their investment in the information commodity, they will under-produce (public good attribute of information).

- Preparation Costs
- Competitive or Proprietary Costs
- Contracting Costs (same numbers are used in contracts)

Financial Reporting Regulation

- So while companies have incentives to provide reports but there may be costs → leads to underproduction ... referred to as a market failure and may lead to regulation can induce additional information production
 - *Scoundrels* -- some companies try to fool the market (Crash of 1929) -- have other incentives for short-term gain.
- Standards (and enforcement) can increase confidence in capital markets and make the information more useful (e.g., comparable).
- Specifically, regulators (SEC and the FASB) step in:
 - protect investors and creditors from scoundrels.
 - everyone benefits if markets work better -- lowers overall cost of capital.

Observations on the Framework

- Evidence of Benefits / Costs?
 - High Quality Reporting -> lower cost of capital.
 - Low Quality Reporting -> pay dearly...

Enron Shares Dn 9% After SEC Asks For Data From Company (DOW JONES NEWSWIRES -- October 22, 2001)

Enron Corp. (ENE) shares sank to a 52-week low Monday after the company said it had received a request for information about "certain related party transactions" from the Securities and Exchange Commission.

- **Collateral Damage:**

Stocks Pummeled as Worries About Accounting Abound (THE WALL STREET JOURNAL ONLINE, February 21, 2002)

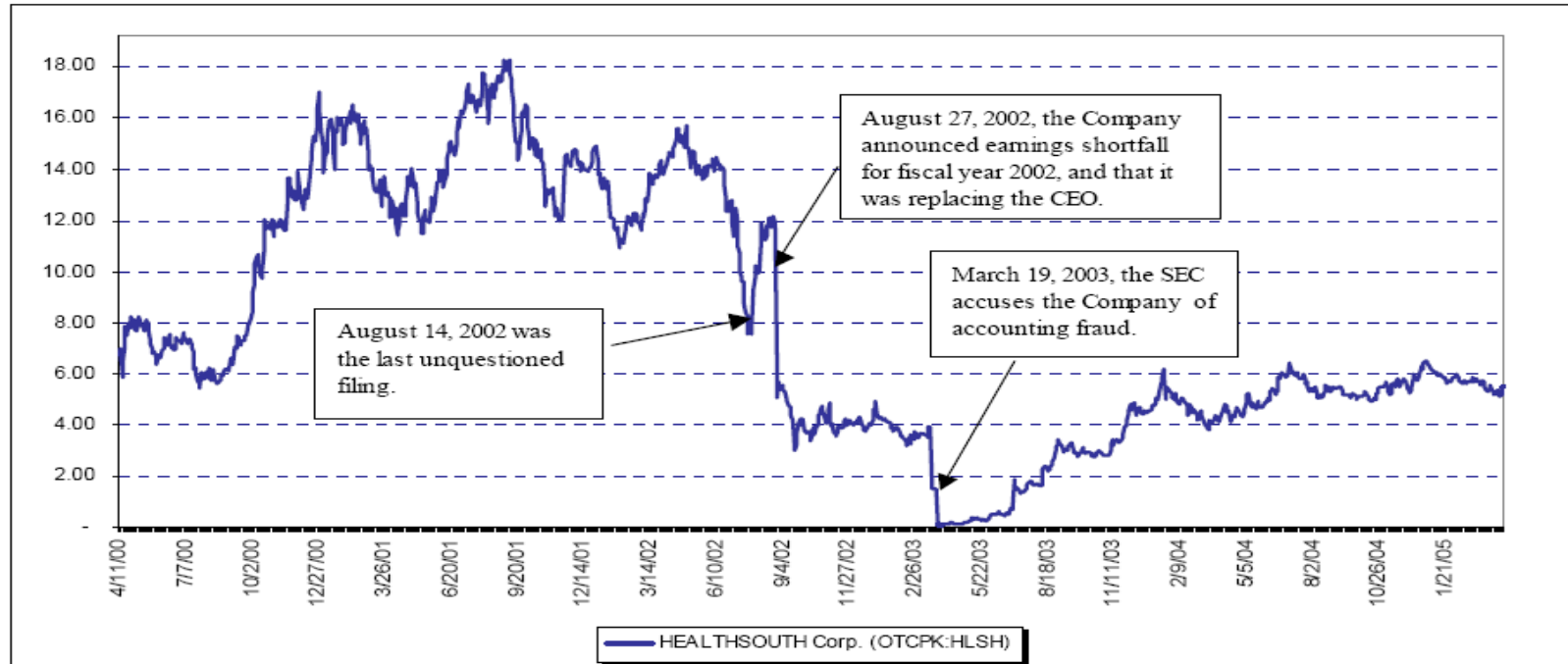
Stocks suffered deep losses Tuesday as continuing accounting concerns weighed heavy on investors' minds, dragging down big names like International Business Machines, J.P.Morgan Chase, Disney and Nvidia.

- And is continuing... Silicon Valley Bank, Restatements around accounting changes.

Accounting Measurement

Company Case Study – Healthsouth... I could show you dozens more...

Health South (HLSH)



Source: GLC, Capital IQ.



Quality of Accounting

These are the real consequences of *unethical* accounting judgments → negative impact on accounting quality.

What is earnings or accounting quality?

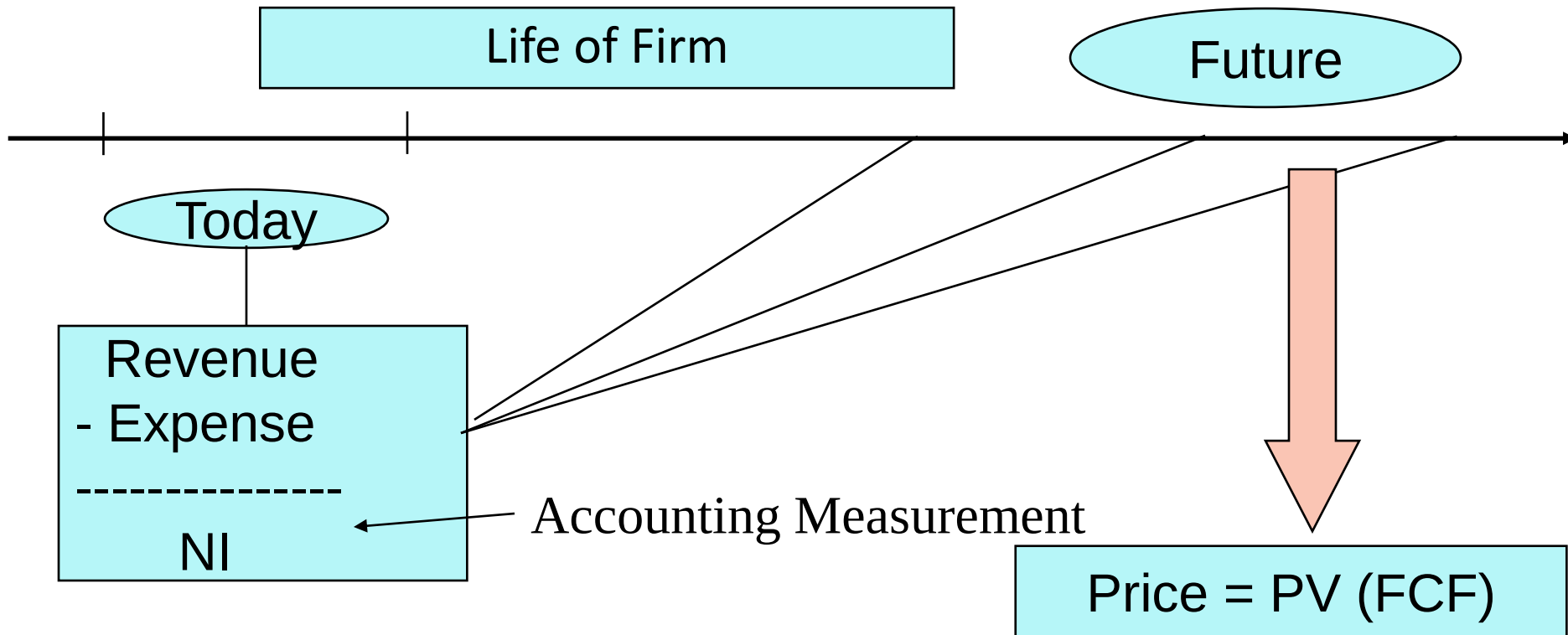
- Current earnings or accounting measures exhibit higher quality to the extent that they accurately reflect the economic substance of firm activities.
- Relevant to assessing firm value, including assessments of risk.
- Such high quality measures can then be used to predict future firm activities (cash flows).

Links to the cost of capital.

Financial Reporting

Quality of Accounting

Economic Environment



Accounting Measurement

- The role of judgment – GAAP is not black and white.
 - Judgments / choices between and within accounting methods.
 - Can affect the quality of current period accounting reports... less useful for predicting future cash flows.
 - If not fully explained, can lead to an information discount... increased cost of capital.
 - Poor judgments in current period can lead to restatements in future periods.
- Why are choices allowed?
 - Accrual accounting provides better information!

Example – Real Life Case Study

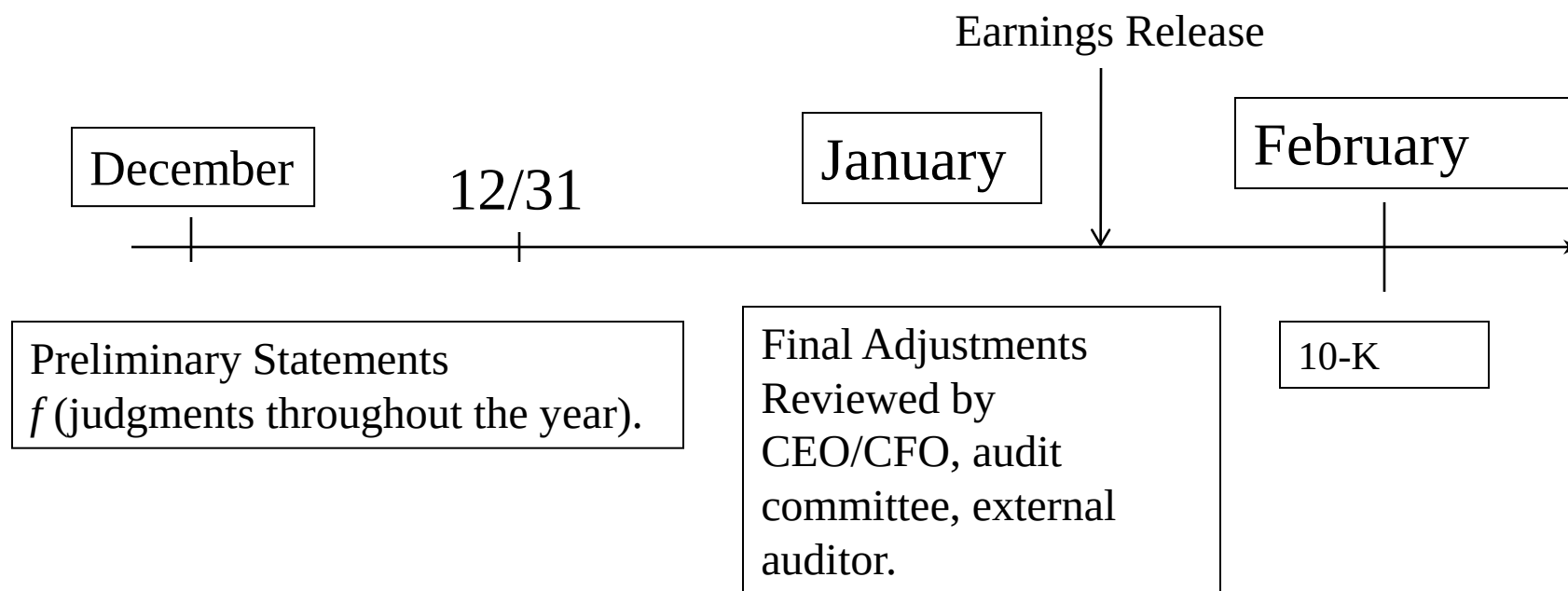
- Context

- High growth company, beginning to turn the corner – wants to impress the market.
- End of the quarter / year; preliminary accounting process indicates that they are a penny short of meeting analyst forecasts (need/want to find ~ \$150,000 – with rounding, get to \$.20 per share).

The end-of-year adjustment process presents a number of possibilities...

Factors affecting quality... accounting adjustment process -- judgments.

- Closing Process



Accounting Options

- Reduce the litigation accrual
- Classify a profitable investment as Equity Method – “Equity Pick-up”
- Lease (increase discount rate, extend estimated useful life), → reduce lease expense.
- Deferred tax valuation allowance.
- Others?
 - R&D, Advertising; Why not?

All of these adjustments are legal (within GAAP). But are they ethical?

Accounting Judgments

Opportunistic Vs. Efficient Accounting Judgments

Any accounting judgment that is made to meet an objective other than presenting a ***faithful representation*** of the underlying economics of the transaction can have negative consequences for the ***credibility of financial reporting...***

Lowers Reliability (Less Rep. Faithful, Verifiable, Neutral)

Can earnings be of lower quality when understated?

Take a bath, smoothing, use of allowances.

Watch out for conservatism... earnings can be of lower quality when understated – that is called bias. Bias in one period can be used for opportunistic reporting in future periods.

i.e., make it easier to “make your numbers”.

When will accounting numbers exhibit lower quality?

1. Judgment in applying Allowable measurement rules (GAAP) to similar transactions → may give results not consistent with economic substance:
 - Case Examples
 - Litigation accrual
 - Valuation allowance
 - Lease
 - Investment classification
 - How have the underlying economics changed to support changes in the judgments underlying the preliminary statements?

When will accounting exhibit lower quality?

2. Non-recurring items:

- extra-ordinary items, discontinued operations, accounting changes, restructuring charges (below the line?)
 - Can earnings be of lower quality when understated?
Take a bath, smoothing, use of allowances.
 - What about “Pro-Forma / Non-GAAP Reporting” (EBS)?

Quality is reduced because investors can not compare between companies or the same company over time.

When will accounting exhibit lower quality?

3. What about the balance sheet?

- By keeping liabilities off the books, ***perceived*** risk is lower
 - Off-balance sheet debt, guarantees -- SPEs
 - Lease Obligations
- By keeping assets off the books, return ratios (ROA) and turnover ratios can be overstated.
 - Securitizations – SPE's
- Derivatives...(may miss-represent risk exposures)

Accounting Quality -- Observations

1. Accounting measurement and financial reporting involve many judgments. **Discretion** is permitted to allow companies to best report the effect of transactions on earnings and financial position.
2. Our examples illustrate, **even in the absence management opportunism**, accounting reports can exhibit low quality – not useful in predicting future cash flows.
3. Other factors – credibility of reported numbers (internal controls, audits, etc.)



Principle vs. Rule-Based Standards

- Consequences – all parties in the framework introduced earlier are affected:
 - **More judgment** by management and auditors, and likely disagreement – comparability could suffer.
 - Different **enforcement standards** to assess meeting of objectives vs. complying with rules.
 - There will **be more volatility** under an asset /liability measurement model... to the chagrin of preparers... (e.g., Pensions/OPEBs, Fair Value)

On the Horizon

- FASB has completed several major projects in which the accounting demands more judgment:
 - Revenue Recognition (now being implemented)
 - Leases
 - Loan Impairments (CECL) based on expected losses.
- What about ESG required disclosures, as proposed by the SEC?

Will managers answer the call to use judgment inherent in these standards to make financial statements higher quality or give in to other pressures.

“Principled” Accounting

- Consequences of these judgments... how do we ensure transparency...
 - Companies (management) must assess whether accounting judgments serve to meet the objectives as articulated in the principle-based standards (already are under SOX and may expand within this framework).
 - Audit committees are key – have knowledge and information needed to effectively serve in this role... more on this later.
 - Requires adherence to ethical judgment principles.



Summary on Accounting Quality

We have identified the factors that affect accounting quality and the consequences of low quality accounting.

Bottom Line -- If all parties embrace the objectives of greater transparency ("*Principled Accounting*"), we may overcome the risk that the judgment inherent in principle-based standards will drive financial reporting to the lowest common denominator.

- **Principled-Based** Accounting Judgments, good disclosure (critical accounting policies).
- **BUT**, must consider management incentives – impact on accounting quality.

Accounting Quality – Management Discretion / Incentives

Another dimension of the fissure... mechanisms to help align managers interests with shareholders:

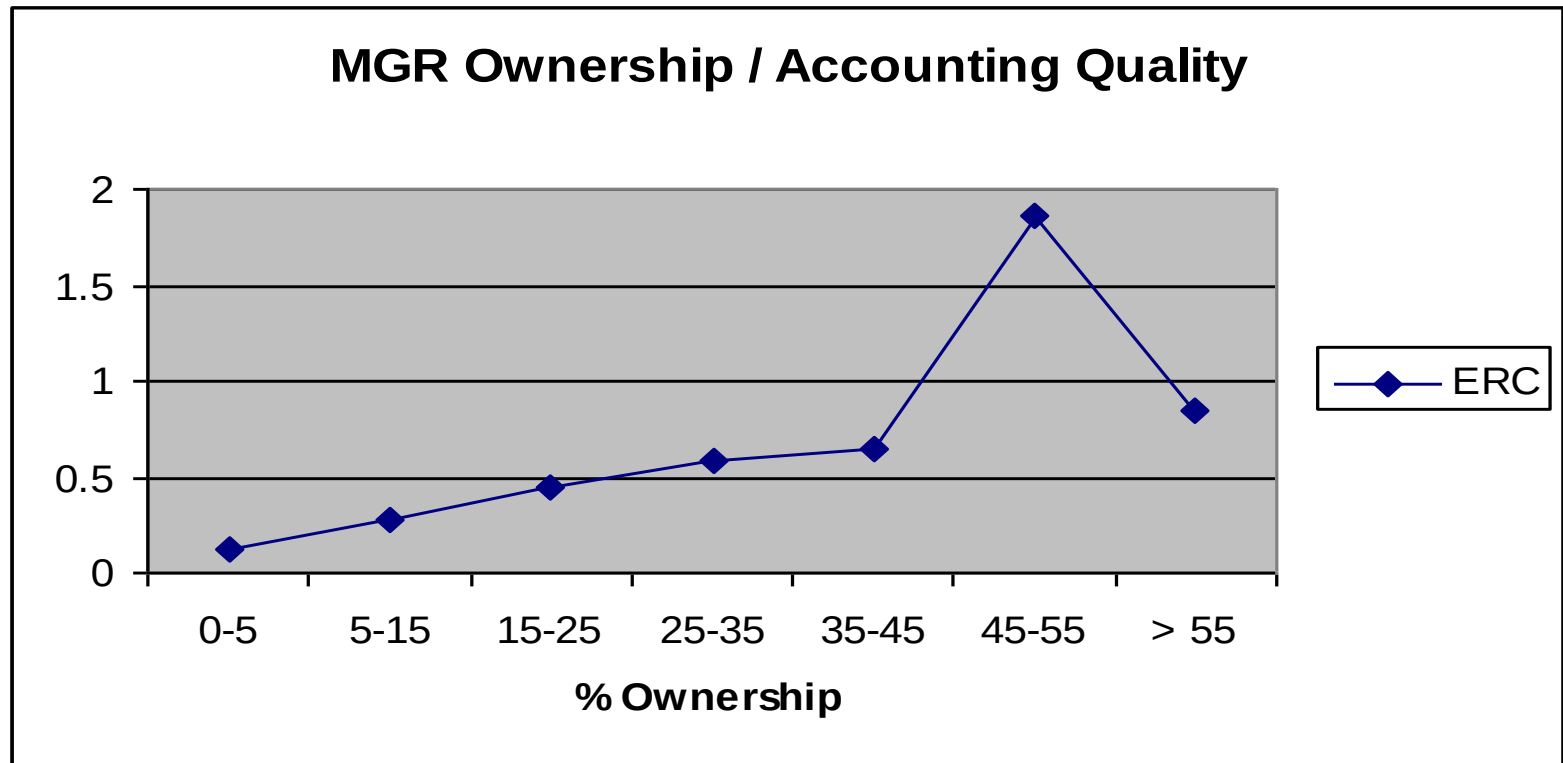
- Bonus based on earnings (1960s – 1970s)
 - Shields managers from market volatility
 - BUT – creates incentives for ***Opportunistic earnings management***

Opportunistic Earnings management:

- Reduces the quality of earnings
 - Lose incentive alignment benefits
-
- Evidence from my research... next slide

Accounting Quality Effects -- Manager Ownership

- Monotonic increase in accounting quality with higher MGR ownership – higher ownership → less demand for accounting constrained contract (bonuses):



Accounting Quality – Management Discretion / Incentives

So inducing managers to own more shares would seem to be the silver bullet to address the accounting quality deficiencies arising from the separation of ownership and control (fundamental fissure) ...

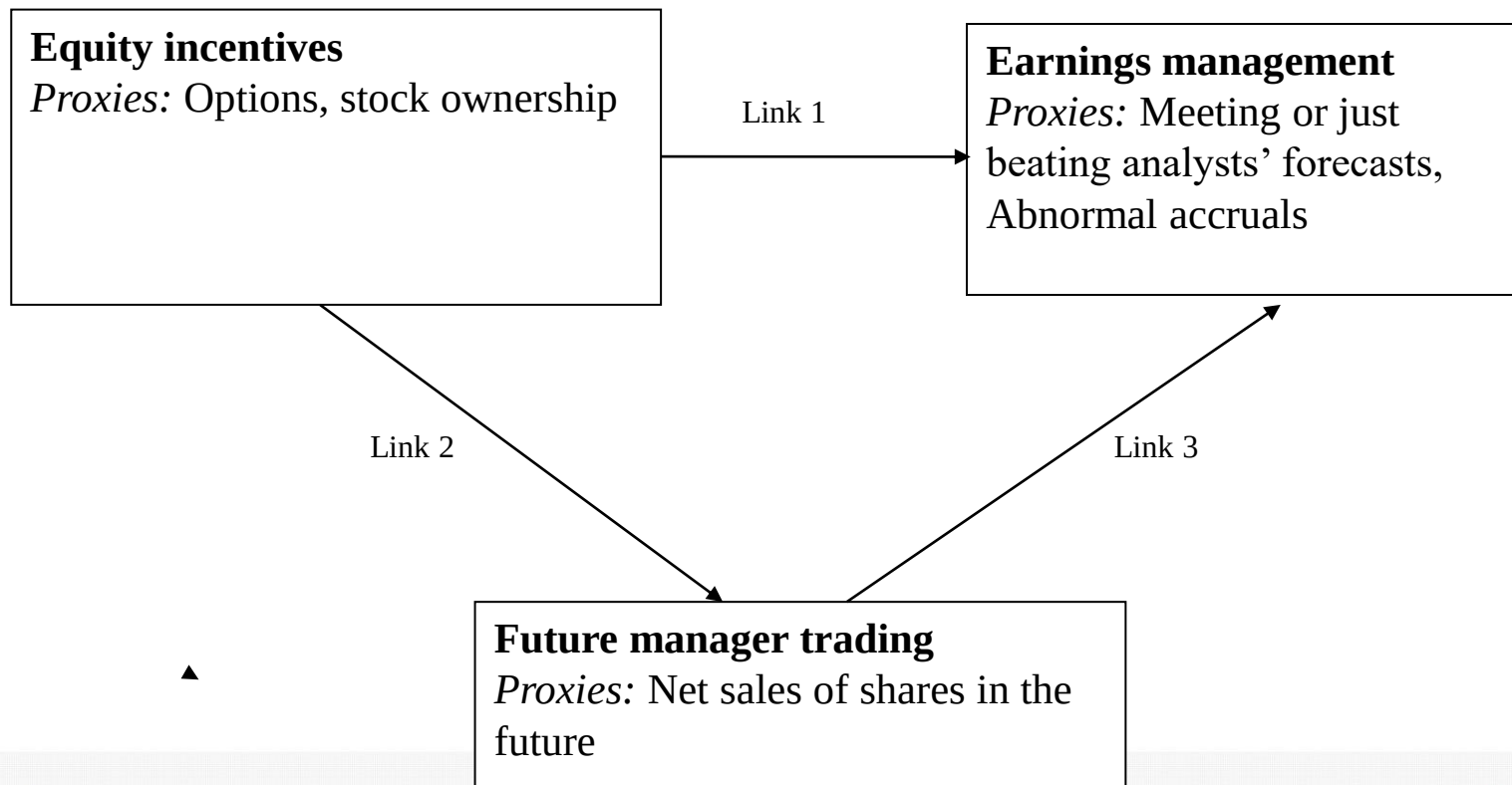
Pay managers with stock-based elements – give them a piece of the action... then they will think like owners.

Not so fast – have to be careful how the stock-based compensation plan is structured... may still get Opportunistic earnings management.

- Theory / Evidence ... next slides

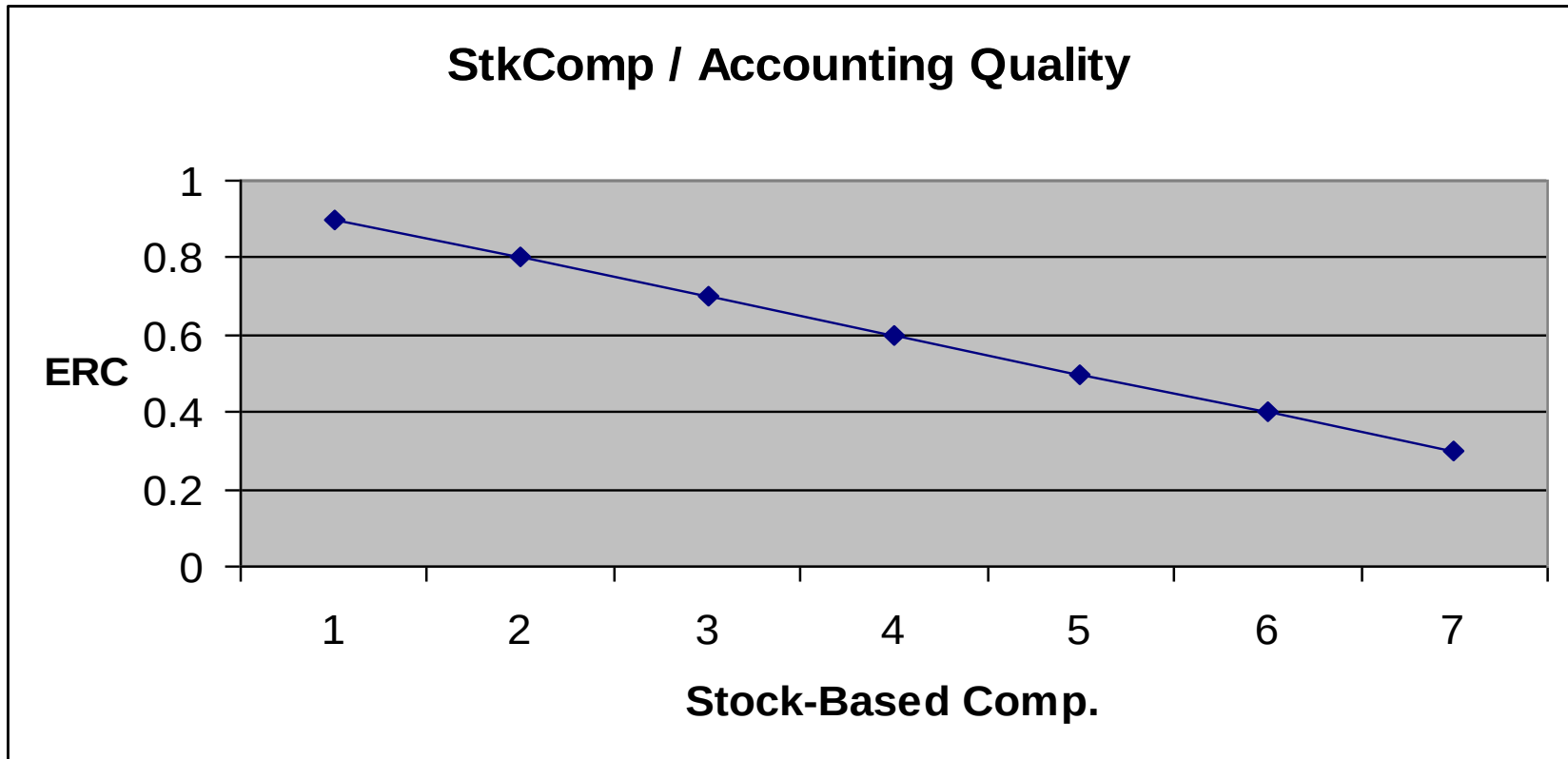
Stock-Based Compensation → Earnings Management

- Theoretical links (Cheng and Warfield 2005, Cheng et al. 2011)



Stock-Based Compensation

- Monotonic decrease in accounting quality with higher stock-based compensation (Cheng & Warfield 2005):



Accounting Quality – Management Discretion / Incentives

- How was this allowed to happen?
 - No expensing of the cost of the options – not transparent
 - Shareholders (including directors) were also benefiting from earnings management induced share price appreciation.
- Once the market cooled, and those accruals reversed, shareholders got a rude awakening ... but managers had already cashed out.
- Response
 - “Perp walks”
 - Changes in Compensation plans
 - Sarbanes Provisions
 - Penalties on ill-gotten gains - clawbacks
 - Greater oversight by audit committees of accounting judgments.
 - Renewed focus on transparency...

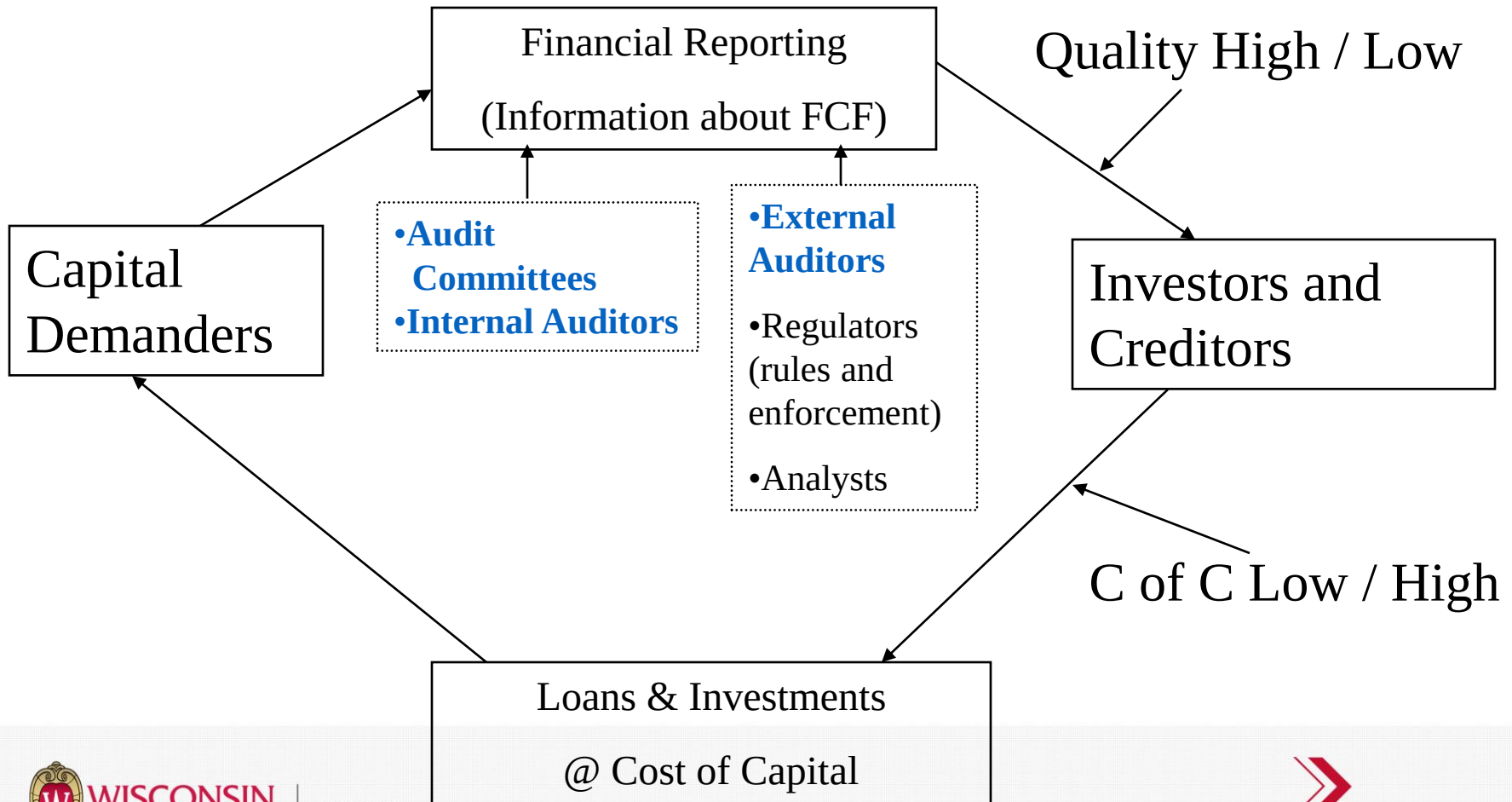


Action Plan -- Accounting Transparency

- Companies can drive ethical accounting judgments to support high quality reporting.
- Governance elements:
 - Tone at the Top
 - Audit Committee Oversight
 - Renewed audit demands (Internal & External)
 - Internal controls

These elements (and other institutional factors) – **under attack?** -- enhance the quality of the outputs from the accounting measurement process and enhance the credibility of the process itself.

Good Accounting Judgments in Financial Reporting



Summary

- Good Accounting provided by good (**ethical**) accountants is key to ensuring credible, high quality reporting.
- This is the product of the financial reporting process -- and why accounting/finance professionals are valued in the marketplace.
- Use accounting “power” wisely...
 - Use accounting knowledge to provide high quality reporting.
 - Avoid the “dark side” -- do not become engineers of transactions that serve objectives other than those related to high quality, credible reporting.