7-1994

Earnings Manipulation: A report by Robert LaVine on the business ethics research of Kenneth Rosenzweig and Marilyn Fischer

Kenneth Yale Rosenzweig
University of Dayton, krosenzweig1@udayton.edu

Marilyn Fischer
University of Dayton, mfischer1@udayton.edu

CHARTERED ACCOUNTANTS JOURNAL of New Zealand

Volume 73 Number 6 July 1994

Editor
Angus McLeod
Production Co-ordinator
Bill Patterson
Publications Co-ordinator
Philippa Woodcock
Editorial Assistant
Alison O'Connor
Publications Sales Officer
Margaret Ryan

CIRCULATION
13,200 of issue printed
ABC total net circulation — 12,345

PUBLISHER
The *Chartered Accountants Journal* (formerly the *Accountants' Journal*) is published monthly (except January) by the New Zealand Society of Accountants, Willbank House, 57 Willis Street, Wellington 1, PO Box 11342, Wellington, Telephone (04) 473-8544, Fax (04) 472-6282.

PRINTER
The *Chartered Accountants Journal* is printed by Format Publishers Ltd, Petone, Wellington

ADVERTISING
Wellington
Sue Archibald
Print Advertising
First Floor, 216 Willis Street,
PO Box 3016, Wellington
Telephone (04) 801-6187,
Fax (04) 801-6261
Auckland
Maureen McCort
Print Advertising
Level 6, 6 Cawley St, Ellerslie,
Auckland
PO Box 12-712, Penrose, Auckland,
Telephone (09) 579-0707
Fax (09) 579-0797

OTHER INFORMATION
Member: Magazine Publishers Association and the New Zealand Audit Bureau of Circulations.
ISSN 1172-9929

These were all factors which should have triggered further inquiries by the bank, which had acted somewhat carelessly.

The president of the court, Justice Kirby, was his usual forthright self in saying the Law is "carefully drawn upon the assumption that facts, putting a person dealing with a company on notice of some irregularity in the company's indoor management rules, will continue to have the invalidating consequences provided by the common law."

The other two judges were sure of the outcome of the case, but not so sure of the precise meaning of the section in question.

Justice Priestley saw the provision as turning on what the person "in the particular situation acting reasonably would have known".

His Honour did not equate this as necessarily the same thing as being put on inquiry, although he acknowledged that the two concepts may overlap.

He thought the latter concept involved features which meant the outside person should have made further inquiries to satisfy himself or herself that all was well.

Gerah Imports v The Duke Group Ltd (in liquidation) concerns the professional indemnity insurance cover held by accountants.

The decision of the Full Court of South Australia is subject to whether the High Court will entertain a further appeal.

The accountants had acted for the failed company, and the liquidator wished to evaluate whether it was worth suing them for negligence.

He therefore endeavoured to question them about the extent of their professional indemnity insurance, and whether they would be able to meet any damages awarded against them.

Not surprisingly, the accountants resisted such questioning on the grounds that it was not concerned with the company's affairs.

But the Full Court was not impressed, and held against the accountants.

The negligence action was the company's main asset, and the liquidator was entitled to inquire about its worth — did a reasonable prospect exist of the damages awarded ever being paid?

The end bit

The drought in Queensland has broken in many places, but by no means everywhere.

One farmer told me he expects 30% of graziers will leave the land permanently in the next year or two.

Lower interest rates are helping some, and the cocky is the eternal optimist, but many will still be forced to give up the only life they know.

One sold his sheep for lc each, as he found this less painful and costly than shooting them.

Sir William Allen is Queensland's most productive grazier.

His family has been in the business since the 1860s.

He refused to shoot his sheep and managed to hang on — and he has been paid $727,000 for his pains.

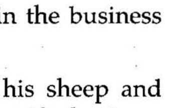
He held Australia's largest private sheep auction recently at his Alice Downs and Athol stations.

The merinos sold like hot cakes, averaging $17.45 with a top price paid of $22.50.

Optimism has returned with the rain, meaning the highest wool prices for two years.

"It's amazing how a bit of confidence is such a magic thing," Sir William said.

Robert LaVine



UNITED STATES

Earnings manipulation

WHILE they are intolerant of accounting ploys, many senior accountants — both internal and external auditors — shrug off earnings manipulations, according to a recent study by the University of Dayton.

Despite the crippling malpractice suits against companies and their CPA firms in recent years, senior accountants have been succumbing to corporate pressures to make end-of-year earnings look better.

Experienced accountants were more tolerant of such manoeuvres than their younger colleagues.

These are the main findings in the survey by Kenneth Rosenzweig, associate professor of accounting, and Marilyn Fischer, assistant professor of philosophy.

It is the result of a study of 265 accountants who rated 13 management actions on a five-point scale, ranging from "ethical" to "totally unethical".

The senior group exhibited fewer ethical qualms about permitting management to offer customers attractive prices at year-end to pull in sales from the next year in order to bolster current-year earnings.

However, they were more sensitive about allowing accounting manipulations such as recording an expense in the wrong year.

"My gut feeling," Professor Rosenzweig said, "is that biased reporting is pervasive. There's a lot of opportunity for companies to influence the reporting of their earnings.

"It's a real concern to us that higher level people are more tolerant of earnings management."

Noting that younger accountants appear to display higher ethics, Professor Rosenzweig said, "People come in with high standards, and those may get compromised by the pressure of corporate life.

"It could be that persistent pressure for short-term earnings growth tends to diminish accountants' ethical values, particularly with regard to manipulation of earnings."

Professor Rosenzweig continued that he and Professor Fischer did not find any significant differences in the attitudes toward earnings management between accountants employed in CPA firms and those employed in companies.

"However, we did find that the attitudes of CPAs differed significantly from [accountants] not holding that certificate, with respect to their attitudes concerning operating decision manipulation of earnings."

These differences held in terms of dealing with both operating expenses and revenues.

However, in relation to both of these factors, CPAs were more tolerant of earnings management than non-CPAs.

"Apparently, CPAs are more willing than non-CPAs to allow management to manipulate earning by means of operating decisions, although they are unwilling to do it themselves by means of accounting methods," Professor Rosenzweig said.

One explanation the authors offer is that while generally accepted ac-

counting principles provide some protection, interpretation of accounting rules varies.

"The dividing line between ethical considerations and good management decisions is fuzzy," according to Professor Fischer.

"The incentive system shouldn't hinge so directly on how good the numbers make accountants look — that pressures them to make short-range decisions."

Deterring distortion

The professors propose several ways companies can deter distortion of reported earnings:

- introduce ethics awareness seminars and workshops;
- introduce an ethical code with policies on both accounting and operating manipulation;
- adopt a monitoring procedure; and
- recruit employees with ethical sensitivity to earnings management.

Although the Institute of Management Accountants displayed the report in a four-page article in a recent issue of its publication, it does not support the findings.

"We open the magazine to thoughts of all kinds, regardless of whether we agree with them," said Dan Hrisak, an IMA spokesman.

Former IMA managing director Alfred M King vehemently objects to the study.

Mr King, senior vice-president at Valuation Research Corp, accuses the two professors of bias and emotional reporting.

"Certainly the verb 'manipulate', particularly in the context of accounting, has an unfavourable connotation.

"The term 'earnings management' must be looked at from the perspective of how a business is run, what the owners' objectives are, and how well managers have accomplished those objectives," he said.

"If the authors find it 'distressing' that 'accountants with more experience ... are more tolerant of earnings management', it may be because they were never involved in management.

"I find it ludicrous to think that developing a sales programme to increase sales is manipulation.

"If management did not try to maximise sales, they should be fired.

"There is no ethical judgement involved.

"How such a sound business decision can be construed as an ethical issue demonstrates the distance between academics and the 'real world'.

"I have difficulty defining any of [the authors' examples] as ethical issues.

"Some are just plain bad accounting, and cannot be justified on any basis.

"But since when was incompetence an ethical issue?"

• *See also the feature on ethics in the May issue.*

Bank failure recoveries

The Resolution Trust Corp, the federal agency established to recover the hundreds of billions of dollars the Government spent to protect depositors of failed banks and thrifts, reports that it has collected nearly $500 million in $4^1/_2$ years from CPAs who audited those institutions.

In the six-month period ended 31 March, it collected $238.3 million in fines and settlements from CPAs, mostly from Deloitte & Touche.

During that period, the RTC reported that it also recovered $75.8 million from officers and directors of failed banks and thrifts, and $63.3 million from their attorneys.

RTC still has over 300 additional civil suits pending.

Internal control guide endorsed

After withholding its full endorsement of the accounting profession's proposal on reporting on internal controls last year, the US General Accounting Office (Congress' watchdog / research organisation) now supports an expanded guideline.

GAO comptroller-general Charles A Bowsher informed the Committee of Sponsoring Organisations (COSO) that its framework "merits general acceptance for evaluating the effectiveness of internal controls".

"Substantial benefits will come from more widespread adoption of public reporting by managements on internal controls over financial reporting and safeguarding of assets," Mr Bowsher said.

He further challenged COSO — composed of five leading accounting organisations — to take supporting actions to achieve the full potential benefits of the COSO report by actively working towards that goal.

COSO chairman Gaylen Larson welcomed the GAO's endorsement, crediting successful discussions about the scope of the management report on internal controls.

Mr Larson said reports on effectiveness and efficiency of operations, compliance with applicable laws and regulations, and reliability of financial reporting were now called for.

Further, COSO has agreed that management's report on internal controls should also cover controls over unauthorised acquisition, use or disposition of assets which could have a material effect on the financial statements.

Mr Larson emphasised that this new addendum does not change the definition of last year's report.

However, he noted that it has "resolved the GAO's concerns, and will insure that managements which decide to report publicly on internal controls will do so in a manner that meets the expectations of all interested parties".

Formed in 1985, COSO sponsored the work of the Independent National Commission on Fraudulent Financial Reporting (the Treadway Commission), which later called on COSO to develop a definition of internal control and guidance for evaluating a system of control which could gain general acceptance by the management, auditors and users of financial statements.

Meanwhile, the Institute of Management Accountants reported that US companies are reducing the costs of internal controls by increasing their formal ethics policies.

According to IMA's cost management group, 57% of companies interviewed said they had a formal ethics policy in place, compared with 41% in 1992.

More than half (53%) believe a strong, comprehensive ethics policy reduces the overall costs of internal control.

"This would indicate an informal 'payback' on this policy investment in a quality cost of prevention context," according to Jonathan Schiff, consulting director to the group.

The AICPA's special committee on financial reporting (the Jenkins Committee), which was to have issued its final report in May, now says it will do so in August.

It apparently needs more time to integrate into the external-reporting model information learned from users and preparers of financial statements.