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Bad governance to blame for creative accounting

By James D Spellman

Michael Woodford, former Olympus president and chief executive, blew the whistle on the company's fraud. The company later admitted to inappropriate accounting practice

Corporate boards continue to rubber stamp financial statements in which earnings are engineered, toxic debt is hidden "off" the balance sheet, and wishful thinking determines valuations of complex financial products.

Deutsche Bank is the latest accounting story, its board confronting allegations that it failed to recognise up to $12bn (£7.46bn) of unrealised losses during the financial crisis. Leveraged super senior securities were treated as if they weren't leveraged, whistleblowers claim.

Hewlett Packard's directors are also under attack for allegedly failing to catch earlier "serious accounting improprieties"– overstated revenues – when acquiring the software firm Autonomy.

Part of the problem lies in the breadth of choice for applying accounting rules, and nowhere is this more clear than with earnings management, as a recent study demonstrates.

Researchers surveyed chief financial officers to discover that one-fifth of "firms [surveyed] manage earnings to misrepresent economic performance". Only half of earnings quality, the researchers found, "is driven by non-discretionary factors".*

One tool particularly favoured to game earnings – and the financial detectives' red flag is accrual accounting: when revenues are recognised after ownership is transferred or the project is completed – not when the cash is received, as cash accounting requires.

Accrual accounting does make sense. But with much latitude and few Maginot Lines within the accounting rules, and plenty of examples to mimic from past scandals, CFOs are able to inflate income, grow receivables faster than sales, and "keep the books open" beyond a fiscal year's last day to surreptitiously capture more revenue.

Particularly suspect are fast-growing companies, whether it is overly optimistic managers, aggressive accounting, or both, driving the shenanigans.

Badly governed companies are also to blame. Typically, their boards and audit committees lack expertise, are dominated by the board chairman's cronies, and implement remuneration policies that exploit short-term options, which make money when share prices rise, for personal gain.

Court proceedings leading to Olympus Corporation's recent guilty plea provide a textbook example of bad governance, with complicity and poor oversight facilitating a $1.7bn accounting cover-up, one of Japan's biggest corporate scandals.

When companies have board directors who are independent, with a mandate for overseeing both the financial statements and the external audit and who are sophisticated in accounting matters, the use of discretionary accruals falls. Frequency of board and audit committee meetings, too, is a factor.

Harvard University professor Lucien Bebchuk and colleagues narrowed it down to six criteria that are sure to pinpoint badly governed companies.

These are: staggered boards; limitations on shareholders' ability to amend bylaws or amend the charter; supermajority requirement for shareholders to approve a merger; golden parachutes for management and board members; and, prohibitions against "poison pills" that shareholders can use to make a company financially unattractive or dilute the acquirer's voting power should an unauthorised change in control occur.

Accounting misdeeds happen too often, and the consequence is public distrust. To change that, much evidence points to reforming boards. But this seldom occurs, with the power of habit and investor complacency to blame for that. Would stronger regulators implementing tougher rules be better?

Unlikely. Just as rain finds a roof's weak spot, those intent on fraud will exploit the loopholes.

And therein lies the challenge for investors: exert pressure on boards, the regulators, or both. Or use the evidence that helps single out badly governed companies, which are likely cooking their books to make money.

James Spellman is a consultant with the IFC Global Corporate Governance Forum.

**Ilia D Dichev, John R Graham, Campbell R Harvey and Shivaram Rajgopal; Earnings Quality: Evidence from the Field (September 9, 2012).*