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MONEYBEAT

Should You Trust These Financial Reports?

By CHARLEY GRANT
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JONATHAN ERNST /REUTERS

"Don't believe everything you read," the saying goes. Evidently, that applies to financial statements.

Four business school professors surveyed nearly 400 chief financial officers on earnings quality. Their findings, published in the current edition of Financial Analysts Journal, are stark: on average, the CFOs believe 20% of public companies "intentionally misrepresent" earnings using discretion allowed under generally accepted accounting principles. Private company CFOs, on average, pegged the number even higher, at 30%.

Areas highlighted by the survey that provide the opportunity for earnings management include acquisition accounting, pension accounting, and the use of subsidiaries and off-

balance sheet-entities.

It's important to note accounting standards do allow management teams discretion and flexibility in reporting results. And while common motivations cited for those overstating earnings include juicing the stock price, companies that take liberties with accounting choices aren't necessarily flattering their earnings profile. The survey found that as much as one third of earnings misrepresentation could be to revise numbers lower, perhaps to gain leverage in negotiations with stakeholders such as employees.

Still, this should give investors pause. The study doesn't even contemplate so-called pro-forma financial reporting, which doesn't conform to GAAP. The Wall Street Journal found in December that roughly one fourth of public companies used pro-forma results in securities filings last year.

And the study found the magnitude of the misrepresentation within GAAP could be as high as ten cents on the dollar. That could easily be the difference between meeting analyst expectations and missing them; between reporting growth or decline.

Better, then, to not skip over the financial-statement footnotes.

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