www.rsm.nl/discovery

RSM DISCOVERY

Management *Knowledge*

30

2nd Quarter 2017

ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

RSM - a force for positive change

RSM Erasmus ERASMUS UNIVERSITY

How can auditors avoid the perils of aggressive accounting?

By ***Marcel van Rinsum***

How do you solve a problem like aggressive accounting? With some difficulty, some management teams and their external auditors might argue. Especially if they cannot agree on: (a) just what constitutes aggressive accounting; (b) whether or not aggressive accounting is inherently a bad thing, and (c) whether it manifests itself more in one kind of management/auditor relationship than it does in another.

This last element is at the core of a paper – *Disclosure Checklists and Auditors' Judgments of Aggressive Accounting* – I co-authored and which was published in March of this year. I will discuss the content of the paper in more detail later, but for now will try to tease out and communicate some of the key lessons that might interest a wider audience.

The pages of corporate history are littered with examples of aggressive accounting, featuring such landmark events as British & Commonwealth's (B&C) ill-fated purchase of Atlantic Computers and Hewlett Packard's (HP) eerily similar purchase of UK software firm Autonomy more than 20 years later.

Much more recently UK retailer Tesco overstated profits in at least three financial years: aggressive accounting. In April this year the *Financial Times* published a story strongly suggesting that UK credit card lenders might be carrying on the tradition. And the failure of Enron in 2001 provides a spectacular textbook example of what can happen when an auditor fails to identify serious misstatements.[1]

In 1988, B&C acquired Atlantic Computers plc for £434 million, subsequent to a series of market purchases that built up their stake in that company. The acquisition destroyed B&C, as Atlantic had been booking profits that did not exist: aggressive accounting.[2]

In October 2011, HP bought Autonomy in a deal that valued the target at US$11.1 billion, widely described as a huge premium. Just over a year later, HP wrote off around 75 per cent of its investment as it became more familiar with the aggressive accounting practices of its new acquisition.[3]

In October 2014, Tesco reported a 92 per cent fall in profits after writing off £263 million. It transpired that Tesco managers had been over-optimistic in estimating how much the company would receive in rebates from suppliers. In other words, a scandal involving aggressive accounting.[4]

The *Financial Times* credit card story described interest-free credit cards as a ticking time bomb as banks apparently routinely expected eventual future income in the here and now.[5]

The details and complexity differ from case to case but the motives are often staggeringly simple. Two kinds of aggressive accounting can be characterised briefly; both take conscious management to the boundaries of what is reasonable. On the one hand, there is an opportunistic attempt to generate an over-optimistic financial result. This can be achieved by booking anticipated income at the earliest possible time in the product life cycle or by delaying the recording of losses to the latest possible moment. In earlier separate research, we have seen this take place to trigger bonus payments to senior management.

> *"Our research strongly suggests that certain measures taken to improve the accuracy of account reporting can in fact have an adverse impact..."*

On the other hand, and equally opportunistic, if management sees that a significant loss is inevitable in a given accounting period, they might be tempted to exaggerate the loss attributable to that period by making excessive provisions. When carried out by new management following the replacement of a discredited management team, this is often referred to as "deep sixing".

Unless disaster strikes in the next accounting period, they should be able to draw on those excess provisions to restore profits. This would have the added benefit of painting a flattering picture of their management capabilities. But it would represent recovery from an artificially low base.

Disclosure checklists

In our joint paper, we set out to investigate whether the use of a disclosure checklist affects the attitude of the auditor to the company that is paying for the audit, nudging the auditor in the direction of glossing over the use of aggressive accounting. Our results imply that the use of a disclosure checklist does indeed result in a less critical state of mind.

Auditors, like any human, can suffer from unconscious biases and respond to incentives – just as management does – but without realising it. When this happens, the watchdog can become less sceptical and too easily acquiesce to perceived management pressure.

In an ideal world, accountants would ask penetrating questions to establish underlying facts before compiling the definitive accounts. Unfortunately, the real world doesn't always work like that. The real world instead too often places undue emphasis on regulation, replication and standardisation. And as referred to earlier, making the process over-mechanical affects the mindset of the auditor.

The use of a checklist inspires a box-ticking mentality rather than a critical mentality. This is especially true in cases where the auditor feels accountable to a management team with a vested interest in a beneficial outcome. Auditors will tend to give the benefit of the doubt to management and go along with their aggressive accounting methods, after being lulled into a false sense of security by the basic checklist. The glass will tend always to be half-full rather than half-empty.

Our findings have important implications for auditing practice. First, when designing their audit procedures, audit firms need to be aware that downsides exist in the use of disclosure checklists. Although feeling accountable to management by itself has no effect on auditors' acceptance of aggressive accounting, the use of mechanistic checklists can reduce the extent to which auditors remain critical towards their clients. Pro-client bias then looms, thus presenting a subtle yet significant threat to auditor independence.

In stark contrast, auditors working to a separate audit committee will tend to concentrate more fiercely on trying to ensure that the accounts on which they are working deliver a true and fair view of the company being audited. Which is, of course, the principal purpose of independent accounting.

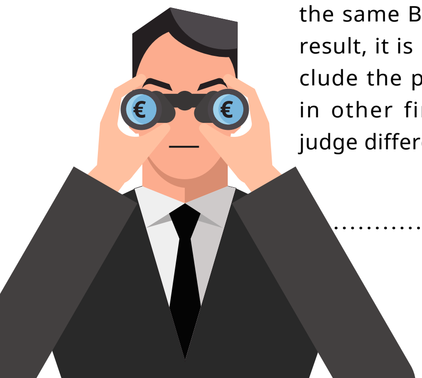
Improving accuracy

Summing up our findings in arguably simpler terms, unintended consequences of the audit process would seem to be at work. Our research strongly suggests that certain measures taken to improve the accuracy of account reporting can in fact have an adverse impact on the independence of those doing the auditing.

"If I am correct that the key issue is awareness, there are ways to help people to refocus."

Our study did not take place in a vacuum but in the context of an impressive body of research and comment on the topic. I believe it points to several avenues for future research. More research is needed on the costs and benefits of decision aids on auditors' judgment and decision-making, particularly on the effects of checklists. Such research could examine other factors that may play a role in how checklist use affects auditors' acceptance of aggressive reporting, such as financial incentives or personality characteristics.

Of course, our study is subject to limitations. One limitation relates to the participants in our experiment who all work in the same region in the Netherlands and for the same Big Four audit firm. As a result, it is not possible to fully exclude the possibility that auditors in other firms or regions would judge differently.



How, then, do we fix aggressive accounting and prevent the problems it creates? I've already mentioned the limitations of regulation and standardisation in the policing role. Perhaps we should pay greater attention to the potential that lies in promoting the use of de-biasing techniques.

If I am correct that the key issue is awareness, there are ways to help people to refocus. Prompt them to think of all the possible negatives and inaccuracies that you might find in preparatory work. Expect mistakes to have been made and consider (motives for) possible opportunistic reporting. This helps to reinforce the critical mindset and prevents succumbing to bias.

Another solution is to further strengthen the role of the independent audit committee and reduce management's influence. This is an essential part of the journey towards arriving at a genuinely objective and fair view in the final accounts. ■

This article draws its inspiration from the paper *Disclosure Checklists and Auditors' Judgments of Aggressive Accounting*, written by Marcel van Rinsum, Victor S. Maas and David Stolker, and published online in *European Accounting Review*, March 2017. http://dx.doi.org/10.1080/09638180.2017.1304228

***Marcel van Rinsum** is Associate Professor of Accounting, Department of Accounting and Control, Rotterdam School of Management, Erasmus University.*
EMAIL *mrinsum@rsm.nl*

Sources:

[1] New York Times 29-11-2001 Enron's collapse; the overview; Enron collapses as suitor cancels plans for merger, by Richard A Oppel Jr and Andrew Ross Sorkin: www.nytimes.com/2001/11/29/business/enron-s-collapse-the-overview-enron-collapses-as-suitor-cancels-plans-for-merger.html

[2] bandcstaffregister.com: http://www.bandcstaffregister.com/page2866.html

[3] Fortune magazine 14-12-2016 How Autonomy fooled Hewlett-Packard, by Jack T Ciesielski, http://fortune.com/2016/12/14/hewlett-packard-autonomy/

[4] Financial Times 22-9-2014 Tesco's unexpected item in P&L area by Jonathan Guthrie: https://www.ft.com/content/a5166e08-422d-11e4-a9f4-00144feabdc0;
The Telegraph 23-10-2014, Tesco chairman stands down as company reports 92% fall in profits, by Graham Ruddick: http://www.telegraph.co.uk/finance/newsbysector/epic/tsco/11181629/Tesco-reports-92pc-fall-in-profits.html;
Tesco addresses the issue of 'commercial income' in detail on page 17 of its 2015 annual report: https://www.tescoplc.com/media/1426/tescoar15.pdf

[5] Financial Times 30-4-2017 Interest-free credit cards a "ticking time bomb", bankers fear, by Emma Dunkley: https://www.ft.com/content/a7df4432-2daa-11e7-9555-23ef563ecf9a