ASSESS QUALITY OF EARNINGS AND RISK OF FINANCIAL STATEMENT MANIPULATIONS

Use Current and Expanded Auditing Tools

BY
DR BARRY JAY EPSTEIN

Finance and investment professionals have long spoken of "quality of earnings", a phrase generally defined in terms of accounting conservatism and the replicability of reported earnings – that is, that current reported profit has not been driven by non-recurring one-time events or accounting gimmicks. However, in actual practice, obtaining valid information by which to assess quality of earnings has not been easy. The reporting entity's financial statements, including informative disclosures (also called footnotes), are the best place, and sometimes the only place, to begin the analysis. But because of the high-level aggregation of information presented, various aberrations and anomalies, including the effects of financial reporting fraud, they may temporarily be hidden from the outside observers' view. Indeed, auditors have long sought to avoid responsibility for the detection of fraud, and have attempted to educate users of financial statements to their limited role, even as professional auditing standards have slowly ratcheted up the obligation to do so.[1]

However, even if the obligation to opine runs only to the consolidated financial statements, the auditors, if properly applying generally accepted auditing standards (which are quite consistent under varying regimes worldwide), should be able to detect anomalies and distortions from their analytical and other auditing procedures, if these procedures are applied to *disaggregated* accounting data. The odds of detecting manipulations are even further enhanced if forensic-type auditing

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[1] Auditors' efforts to side-step the duty to find fraudulent reporting practices include the decades-long refusal to even use the word "fraud" in auditing standards, instead invoking the more ambiguous term, "irregularities". Only in recent decades have standards forthrightly addressed financial reporting fraud and, in response to demands from the user communities, expanded the obligation to plan and conduct audits to control, at a low level, the risk of undetected fraud having material impact on the financial statements. Earnings management falls within the definition of financial reporting fraud.

procedures are employed, as can be done even in the context of routine annual audits.

USING SOPHISTICATED AUDITING TOOLS

Although accountants and auditors are renowned as "numbers people", they surprisingly have often resisted the use of sophisticated quantitative tools, such as the application of statistical methods, to audit sampling; models to predict insolvency for making going concern evaluations, and analytical procedures more involved than the simplistic "last year vs this year" comparisons that are commonly seen. However, the more knowledgeable and adroit auditors have employed such devices, and auditors practising in the sub-field of forensic accounting are commonly more adept at the use of such tools, including use of the Altman Z-score model for predicting near-term insolvency, regression analyses to detect monthly or quarterly anomalies possibly caused by revenue recognition frauds such as channel stuffing, and variance analyses to corroborate or refute management assertions regarding the effects of changes in product mix.

One area not yet fully exploited is that pertaining to assessment of quality of earnings, although this seemingly would fit nicely into the auditors' toolkit when evaluating management integrity, aggressiveness of accounting policies selected, and risk of financial reporting fraud. Although auditors normally opine on the financial statements taken as a whole, and not on specific accounts or transactions, clearly they must examine – on only a test basis, of course – detailed transactions, and they must furthermore have access to the reporting entity's books and records, thus facilitating drawing-down detailed information on, say, sales of a given product, or those made from a given location, or those made to a given customer. It is in the detailed data that fraud will normally be identified, other than those instances (WorldCom was one example) where the effects of fraud were so enormous as to be visible, ultimately, even in the highly aggregated consolidated financial statements. In other words, attention to disaggregated financial statement data is necessary if financial reporting fraud is to be more frequently uncovered, and if earnings management attempts are to be detected.

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If auditors were to apply standard audit and forensic-like tools, including more highly developed analytical methods, to disaggregated company information, this would serve two purposes. First, it would make the certified audit more meaningful and more likely to comply with both the letter and the spirit of the definition of an independent examination. And, second, it would contribute to the reporting of better information to stakeholders, including that which would provide insights into quality of earnings, because once uncovered by the auditors, there would be enhanced pressure on management to provide clearer, expanded discussions in the financial statements and in corollary information, such as the management discussion required for public company filings and increasingly used even by private companies for reporting to lenders and other interested parties.

UNCOVERING FRAUD, DETECTING MANIPULATIONS

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of deteriorating quality of earnings. For example, if the reporting entity changed the accounting method being used for a given class of transactions in the current year, the auditors' use of variance analysis to break down the "last year vs this year" number according to underlying cause – for example, price change, volume change, product mix change, and effect of change in accounting principles employed – this could provide analysts and others with actual evidence of the earnings quality effects.

A model developed by Professor Messod Beneish over a decade ago may also be highly useful for assessing quality of earnings.[2] It uses eight indices derived from the company's accounting records for the current and immediate prior years, which are combined into a linear model which results in a numerical score, much as the famous Altman model computes a Z-value, using a variant of regression called discriminant analysis, separating companies likely to face insolvency in the near term from those which do not. The Beneish model computes what is called the M-score by applying another derivative of regression modelling known as *probit analysis*, the end result of which is an admittedly imperfect indicator of the risk of manipulation present in the financial statements, based on characteristics pertaining to rapid growth, deteriorating fundamentals, and use of aggressive accounting methods, which are not only germane to fraud risk, but to quality of earnings concerns as well.

There are other techniques for assessing fraudulent financial reporting risk and its close cousin, deteriorating quality of earnings. One, Benford's Law – which relies upon the non-intuitive distribution of first digits in a series of numbers, such as dollar amounts of invoices presumptively issued to customers – has been used increasingly by both auditors and forensic investigators with good results. Currently, the US Securities and Exchange Commission (SEC) is working on developing a fraudulent reporting model that would identify "red flags" in company filings suggesting possible manipulations and thus the need for closer examination by SEC staff. Presumably this model, if and when completed, will find its way into the public domain as well. Private sector financial analysts and some academicians have also developed variations on these "red-flag" warning devices to single out financial reports having attributes of possible manipulation.

Little or none of these efforts have been tracked adequately by the auditing profession, which is thereby missing the chance to apply "cutting-edge" tools to financial statement examinations. In the cat-and-mouse game that is carried out between managements intent on committing financial reporting irregularities and their companies' auditors, the auditors can ill afford to be constantly playing catch-up, but history demonstrates that such has most often been the case.[3] If the auditing profession were to seek to collaborate with other interested groups, including financial analysts and regulatory bodies, this could increase the likelihood that future developments will further all of their respective objectives. If properly constructed, new or enhanced analytical tools might well usefully accommodate all their myriad needs. **ISCA**

[2] Messod D. Beneish, "Earnings Management: A Perspective", *Managerial Finance*, Vol. 27, Issue 12 (April 2001), pp. 3-17

[3] Many now-accepted standard auditing practices, such as observation of inventories and confirmation of customer receivables, were only added to auditors' repertoire of mandatory procedures in response to major financial reporting frauds.

Barry Jay Epstein, *PhD, CPA, CFF* is a Principal at Cendrowski Corporate Advisors (www.cca-advisors.com) and the co-author of *Wiley GAAP 2010*, *Wiley IFRS 2010*, *Wiley IFRS Policies and Procedures*, the WG&L *Handbook of Accounting and Auditing*, and other books.