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The problem of management bias in accounting estimates: An investor perspective on root causes and solutions

Thomas I. Selling[a,*,1], Bo Nordlund[b]

[a] Cox School of Business, Southern Methodist University, Dallas, TX 75275, U.S.A.
[b] Royal Institute of Technology, Stockholm, Sweden

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Abstract The standards of the PCAOB implicitly, yet unmistakably, presume that auditors are capable of eliminating the material effects of management bias by constraining point estimates to a 'reasonable' range. Yet, from inspection results of the PCAOB and its global counterparts we can confidently infer that auditors far too often fail to exercise sufficient skepticism of management's estimates. The consequences could be profound. Therefore, we are proposing fundamental changes to the rules of engagement between the auditor and its client. We would, incrementally over time, transfer the responsibility for financial statement judgments to independent appraisers. Auditing would become solely a verification service, and financial statements would better serve investors and the public interest.
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1. Introduction

Estimates by management are ubiquitous in accounting. They are in the economic lives of buildings and machinery, the loan loss allowances of banks on the debts of the Greek government, and practically everything else in between. It would not be an understatement to claim that the quality of modern financial reporting rises and falls with the collective integrity of management's estimates.

Regarding the audits of estimates, the reality is that putatively 'independent' financial statement auditors effectively serve at the behest of management. Yet, the standards of the Public Company Accounting Oversight Board (PCAOB) implicitly, yet unmistakably, presume that auditors possess the technical capabilities and ethical resolve to eliminate the material effects of any management bias by constraining point estimates to a 'reasonable' range. Recently, however, that presumption has been called into question by the inspection results of the PCAOB and its global counterparts,

* Corresponding author
E-mail addresses: tom.selling@grovesite.com (T.I. Selling), bo.nordlund@brec.se (B. Nordlund)

[1] Thomas I. Selling is a member of the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB). The views expressed in this article are his own and do not necessarily reflect the views of the PCAOB or its staff.

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from which we can confidently infer that auditors far too often fail to exercise sufficient skepticism of management's estimates.

Thus, it would seem unlikely for anyone to deny that management bias pervaded the financial statements of key financial institutions leading up to the Financial Crisis of 2008, yet views differ on the role of financial reporting in the crisis and how accounting regulators should react. For example, in the recently published memoir of his time as chair of the Financial Accounting Standards Board (FASB), Robert Herz (2014, p. 145) recounts how he repeatedly claimed that financial reporting did not cause the financial crisis, yet "it did reveal a number of areas requiring improvements in standards and overall transparency."

But given the many ways that financial reporting has been implicated in the financial crisis, there can be little doubt that it must have played a significant role, even if it did not actually cause the financial crisis. Issuers use financial statements as a basis for governance of all manner of corporations, creating incentives for managers to manipulate reported financial results by any number of means. They also use financial statements to make capital allocation decisions. And perhaps most importantly in the context of an economic crisis, financial regulators rely on financial statements to measure the capital adequacy of financial institutions subject to their oversight.

The New York Times economic policy columnist and Nobel laureate Paul Krugman (2009) rarely comments on financial reporting matters. But in one piece, he succinctly delivered a much harsher judgment:

> So here's what Mr. Summers [Secretary of the Treasury]—and, to be fair, just about everyone in a policy-making position at the time—believed in 1999: America has honest corporate accounting; this lets investors make good decisions, and also forces management to behave responsibly; and the result is a stable, well-functioning financial system. What percentage of all this turned out to be true? ***Zero*** [emphasis added].

Perhaps due to such differing views, most would agree that fundamentally very little has changed about financial reporting since 2008 to make a noticeable difference. As evidence, there have been numerous recent developments to indicate that financial reporting remains inadequate to meet the needs of the public interest in a transparent, efficient, and stable economy. Consider the following:

- With respect to accounting standards, quality-critical agenda items are proceeding at a snail's pace. These include valuations of debt, loans, and other financial instruments; classification of a financial instrument as liability or equity; leases; and the general incomprehensibility and incompleteness of financial statement disclosures. And, it is not even clear that successful completion of the current docket will result in actual quality enhancements. For example, the FASB and International Accounting Standards Board's (IASB's) joint revenue recognition project is already 12 years in the making, and may be further amended before it is finalized—which could take another 3 years. Although a 'final' converged standard has been issued, the costs of implementation in the U.S. will be high, there will be greater reliance on management's estimates, the informational benefits are purely speculative and highly debatable, and it does nothing to address the accounting deficiencies most closely associated with the financial crisis.

- In October 2010, the European Commission (2010) issued a report titled *Audit Policy: Lessons from the Crisis*, the first paragraph of which states: "The fact that *numerous* banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet raises. . .the question of how auditors could give clean audit reports to their clients for those periods" [italics added]. Yet again, it is far from clear that any of the proposals from the FASB (or IASB) are sufficiently broad in their scope, or whether the proposed new measurement guidance based on a new battery of management estimates would be an improvement.

- In April 2014, the International Forum of Independent Audit Regulators (2014) published the results of its survey of inspections taking place the prior year, in 2013, of the audits of the six largest firms worldwide. It expressed grave concern for the numerous deficiencies involving the examination of estimates in general, and fair value measurements in particular.

- In an inspection report dated October 21, 2014, the PCAOB (2014a) disclosed that of 23 audits inspected for a major international auditing firm, 65% were completed without obtaining sufficient information to support its opinion.

The IFIAR report referenced previously also states that it expects the firms to provide information about the results of root cause analysis of the factors that underlie the inspection findings and to take appropriate remedial actions. Yet, only one of the

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