Earnings Management – Myths and Realities
This booklet summarizes the results of presentations and panel discussions of the conference “Earnings Management – Myths and Realities”. The conference was held on 24 October 2005 at SWX Convention Point as the third event in the Ethical Finance Research Series.

Ethical Finance Research Series
The Ethical Finance Research Series provides a forum for fostering intellectual exchange among academics and practitioners on issues affecting today’s financial industry with a focus on ethical concerns. The general purpose of this series is to provide professionals with comprehensive knowledge on current academic research and to stimulate ethical discussions between academics and practitioners. For more information, see www.nccr-finrisk.ch/ethicalfinance.

The Series is jointly organized by the CCRS, the Center for Corporate Responsibility and Sustainability at the University of Zurich, and the National Centre of Competence in Research “Financial Valuation and Risk Management” (FINRISK). It is supported by the Swiss Banking Institute, the Center of Competence Finance in Zurich, and the University Research Priority Program “Finance and Financial Markets” at the University of Zurich.

The conference organizers highly appreciate the continuous support of the President of the University of Zurich, Professor Hans Weder.

CCRS
Center for Corporate Responsibility and Sustainability at the University of Zurich

CCRS is an associated research institute at the University of Zurich that aims to enhance the contribution of the corporate sector in realizing sustainability, with focus on the financial sector. To do so, CCRS pursues three integrated objectives: to advance and critically evaluate theoretical and practical knowledge on the role of the corporate sector in realizing sustainability; to provide relevant insights and concrete recommendations to business leaders on issues of corporate responsibility; to contribute to public discussions and shape the political agenda on the role of the corporate sector in realizing sustainability. For more information see www.ccrs.unizh.ch.

FINRISK
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The Swiss National Science Foundation (SNSF) launched the National Centre of Competence in Research “Financial Valuation and Risk Management” at the end of 2001. FINRISK is an academic forum that fosters cutting-edge finance research, education of highly qualified finance specialists at the doctoral level and knowledge transfer between finance academics and practitioners. It is managed from the University of Zurich and includes various academic institutions from Basel, Geneva, Lausanne, Lugano, Neuchatel, St. Gallen and Zurich. FINRISK’s long-term goal is to develop a Swiss Excellence Centre in Finance. For more information see www.nccr-finrisk.unizh.ch.

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The University of Zurich attaches great importance to integrating ethics into research, particularly with respect to business. Recently two University Research Priority Programs – one in ethics and one in finance and financial markets – were launched. Both of these Priority Programs will deal with ethical aspects of business. It is one of the core responsibilities of the University to combine knowledge with high level reflection on ethics.

The topic “earnings management” is highly relevant. Over the last few years many cases of severe accounting manipulation occurred, leading to the collapse of several major corporations, such as Enron, Worldcom, Parmalat, and Refco. The problem, however, did not only concern corporations and banks but also harmed small investors who lost considerable amounts of money.

These recent accounting scandals show that managers sometimes mislead stakeholders about the economic performance of their company. They may produce financial statements that do not provide a true and fair representation of the company’s value. The reasons for this misbehavior are diverse: they include intentions to satisfy expectations or to maintain a competitive position within the financial markets. However, it is not always clear whether a certain level of earnings management is acceptable or has to be considered as fraud.

This conference analyzes both, causes and motives of earnings management as well as possible remedies.

“What is the meaning of truth and honesty within our modern market system – if there is any at all?” Hans Weder
If “truth” is defined as information corresponding to facts, “fraudulent financial information” can be characterized as the provision of untruthful information. These definitions stress the point that for a definition of the term “earnings management”, one must first identify the status of the facts underlying the original accounting statements. Lev argued that there are basically no facts underlying the numbers in financial reports. He supported this statement by providing three examples:

- The accounting process of earnings measurement is based on a set of unrealistic conventions (e.g., that the purchasing power of money does not change), on a multitude of estimates (such as depreciation and bad debt reserves), and on questionable rules (e.g., that the inventory value is written down, but not up). Lev pointed out that there are no “factual earnings”.

- Asset values rely on estimates. GAAP requires the recognition of an impairment of value if the sum of future cash flows is lower than the book value. Clearly, Lev stated, a value based on estimated future cash flows is non-factual.

- The fair value of financial instruments is determined either on the basis of similar instruments or a valuation model, which again relies on numerous assumptions and is therefore, also, non-factual.

In the absence of facts in financial reports, Lev argued, untruthful reporting is defined as the deviation from applicable accounting rules, such as GAAP. However, he made clear that GAAP is a very inadequate system to substitute for truth in the definition of managed or fraudulent earnings. A company conforming to GAAP might provide a picture inconsistent with the underlying economics of the situation. In many cases, following GAAP distorts the economic picture, for example, the practice of immediately expensing R&D and other intangibles. Furthermore, GAAP is frequently too porous, delayed, and politically influenced to substitute effectively for the missing facts.
With this in mind, Lev stressed that this system is hardly an appropriate substitute for the missing facts in financial accounting. He further argued that most manipulations are in fact not created by deviating from the GAAP framework. Instead, manipulation can be achieved by adopting the following two kinds of practice, both of which assure immunity and are impossible to prove. The first is changing the timing of transactions and the second (and more frequently used) practice is to “massage” estimates. Lev once more pointed out that, with some exceptions, practically every item on balance sheets and income statements is based on an estimate which can easily be changed or adjusted by management.

In the second part of his talk, Lev provided several suggestions for mitigating earnings manipulation. He argued that it is highly unlikely that accounting manipulations will be mitigated through current accounting regulation, most importantly because effective standards for honest estimation and forecasting of accounting items are not achievable. Consequently, Lev offered three proposals for enhancing the integrity of accounting estimates:

1. Quantification of the impact of estimates on key numbers in financial reports. Among others, disclosing the aggregate impact of estimates on financial numbers would provide an indication of their reliability. According to Lev, this information is entirely known by management and not costly to produce.

2. Comparison of key estimates with subsequent realizations. Lev argued that if managers were required to explain large deviations between realizations and their estimates, they might minimize the manipulation of estimates.

3. Revision of previously disclosed revenues and earnings if the aggregate difference between estimates and realizations exceeds a threshold. Lev acknowledged that this proposal was perhaps the most ambitious one of the three. However, he emphasized that such a revision procedure is essential to national GDP accounting. If such a procedure is deemed appropriate in national accounting, why not adopt it in corporate accounting?
Raymund Breu provided insights from his experience as a chief financial officer at Novartis. He introduced his talk by examining the question of why earnings management is considered a “bad thing” while earnings and management, taken separately, are regarded as good things.

He highlighted the absence of a clear-cut definition of fraudulent earnings management and suggested the following characterization: “Fraudulent earnings management is the reporting of earnings or cash flow figures that do not reflect the true underlying performance or trend, or that provide a poor and/or deceptive guidance to future earnings or cash flows.” Further, Breu distinguished between two ways of achieving earnings management, namely “real means” and “accounting means,” pointing out that an inconsistency with accounting rules can easily be detected and declared as fraud, while fraudulent earnings management within real means was hard to detect.

With regards to real means, achieving long-term targets or maximizing long-term earnings is certainly not fraud and, arguably, should be the main objectives of a company. However, Breu warned of the enormous impact of a 1% difference in long-term expenditures – such as R&D expenses – on short-term earnings. Reducing those expenses in order to increase current earnings can be disastrous with respect to the long-term value of the firm. Hence, it is questionable whether under-investment over one or several years is always just an honest managerial mistake or whether it should be considered as fraud in some cases.

Over shorter time periods, detecting fraudulent earnings management becomes more tractable. Breu provided two examples from a business unit that highlight the ambiguities involved in determining fraudulent behavior. As a first example, he described the situation of a business unit manager who is behind expectations and reduces marketing expenses in order to achieve his yearly target. As a consequence, the company might suffer in the subsequent period, possibly through lower sales.
The second example concerned a business unit manager who is exceeding expectations and invests the “excess” profits into an entrepreneurial initiative. Here, the profit target would still be achieved and there would be a potential for higher profits in subsequent periods. However, the current profit would be lower than achievable and next year’s profit would possibly be overstated. In both cases it is questionable whether the actions should be considered as fraudulent behavior or just as a managerial mistake.

According to Breu, the distinction between fraudulent earnings management and sound operational business decisions requires an understanding of managers’ intentions, since the latter indicate why a certain decision has been made.

Referring to Baruch Lev’s talk, Breu also claimed that accounting measurements are essentially a fiction and often represent reality poorly. In order to emphasize this he provided an example of an acquired R&D project which requires an impairment test every year. Breu emphasized that even a small change in capital costs, or in the probability of success of the R&D project, can substantially affect the decision to write down or continue with that project.

In order to distinguish fraudulent behavior from strategic decisions, Breu recommended asking certain test questions. One might ask whether the action taken makes economic sense, and what the intention underlying the decision has been. One can also ask whether a specific management decision leads to substantial personal gain, or has been made within the context of increasing pressure to perform. What is the track record or reputation of the team? And also, whether there is a culture of tolerating minor violations.

In summary, Breu talked about how fraud starts at the top. He warned never to forget that reported earnings are a proxy and emphasized the need for managers to trust, but also to verify the information they receive. Finally, Breu spoke of the human factor and stressed that no system, and no culture, will prevent all accidents from happening. The fundamental question is how management deals with a problem once it arises.

“The large portion of managers have no intention of committing fraud.” Raymund Breu
Panel Discussion: Myths and Realities
Raymund Breu, Baruch Lev, Mirko Sangiorgio, David Shirreff, Rudolf Volkart

Trust versus Verification
Citing the British mathematician Raymond Smullyan, Lev claimed that in order to know the past one must know the future, saying that only over time does the truth reveal itself. According to Lev, a system of verification should act as a very serious deterrent against violation. Yet, as was emphasized in his presentation, verification is difficult in the case of accounting; verification can only be performed with facts, while accounting is mainly based on estimates and on approximations. There is no truth and there are no facts. There are only measurements of where a company stands.

These measurements are continuously improved. Such improvement is what accounting should strive towards. The emphasis should be not on trust but rather on systems that provide incentives to mitigate violations.

The panel raised the issue that investors might nowadays have too much information, at least in terms of figures. When figures are disclosed, market participants must react quickly. Sangiorgio made clear that investors have no time to explore hundreds of pages of a particular annual report.

Volkart addressed the issue of overregulation and suggested that reporting should move in the direction of being more qualitative as in Value Reporting, which provides additional information behind accounting numbers. In this context, the pharmaceutical industry was mentioned. Here, the general level of disclosure is higher than average. Investors in the pharmaceutical industry go well beyond the financial reports; their main emphasis is on the product pipeline. This tends to enrich their analysis. It was claimed that consideration of information beyond accounting would reduce the stress on numbers and would lead to better analysis.

The panel explored the role of financial analysts and rating agencies in the verification of company information. In a wide-ranging discussion, some expressed the opinion that although financial analysts and investor advisors are paid well for such analysis, on average the accuracy of earnings forecasts and recommendations was not very high. One panellist claimed this arises because analysts are focused on their own performance. However, rating agencies should play an important role in providing more objective information. Lev pointed out that firstly, rating agencies have an effect on capital markets only in extreme cases, such as downgrading; and secondly, that there is a basic conflict of interest owing to the fact that companies pay for such ratings.
Stakeholders’ Interests and the Market’s Short-Termism

Sangiorgio claimed that, nowadays, quarterly reporting gains excessive attention in the financial market place. While analysts and investors focus on quarterly results, it is simply not the case that companies are led quarter by quarter. Volkart referred to a recent survey by the Swiss Banking Institute revealing that executives deem net profit to be the most important performance measure, while investors and analysts indicate free cash flow as most important. He raised the question as to whether this reveals that the market is moving towards more long-term objectives. He also pointed out that the result is in contradiction with the severe stock market reactions to companies missing projections regarding their earnings per share or net profit.

A participant argued that the market is not as short-term oriented as one might believe. A supporting fact is that the US stock market has been successful in funding biotech companies, which have a very long time horizon and are fairly risky investments. Notwithstanding the long-term horizon of a lot of companies, many are in an incredibly competitive environment. Referring to existing evidence, he claimed that how these companies perform over time scales of one to three years is actually very important with respect to the comparison between their performance and that of their competitors. He claimed that internal pressure to achieve results creates value, although as an unfortunate downside it might also create incentives to manipulate numbers.

Breu claimed that management’s mentality had changed very little after Novartis switched to quarterly reporting. Internally, the business had been managed on a quarterly or even monthly basis even before the change. On the shareholders side, higher reporting frequency led to a higher proportion of US investors. Breu emphasized that in his experience, sophisticated investors are long-term oriented and would even penalize management if they were to cut research spending in order to meet short-term goals.

The panel then discussed the universe of investors, claiming that there are many categories of investors, brokers and fund managers, each with different time horizons. Sangiorgio referred to rapid changes to the entire market that have taken place within the last couple of years. As little as ten years ago, hedge funds “going short” or “long” and other types of investment strategies were hardly used. Today, the increased volatility is due to the activity and the entrance of new investors in the market. A company that does not meet market expectations experiences a stock price correction. Momentum traders will stress the price further in order to gain performance, since they are judged on their short-term performance; this in turn increases volatility.
With respect to the earnings game, Gibson pointed out that, while sometimes both managers and shareholders could win, bondholders would certainly lose. As some companies are highly leveraged, Gibson raised the question of why there are no proactive standpoints from bondholders with respect to earnings management. Lev agreed that bondholders were a constituency that deserved further attention. Bondholders try — and in large part succeed — to protect themselves with covenants. However, little research exists on bondholders’ protection.

Who Cares About the Past?

Breu stressed the difference between reporting historical numbers and talking about future developments. Especially in the pharmaceutical industry, company valuations are mainly driven by perceived future developments. A large share of today’s market value is not explained by current earnings, or by products that are currently on the market. Rather, valuation appears to reflect products that are expected to arrive on the market within the next 10 to 15 years. Hence, sophisticated analysis of very early research projects is extremely important.

Breu emphasized that investors are interested in a company’s prospects and expressed some disagreement with Lev’s proposal to compare previously made estimates with subsequent realizations. He essentially argued: “Who cares?” At the time when numbers have been realized the management who made the initial estimates may have retired. Current investors do not care about what management said five years ago. They only care about the outlook of the business.

Lev replied by referring to one of his recent studies, “Rewriting History”, conducted with Stephen Ryan and Min Wu. The study addresses the question of “Who cares?” by using a large sample of earnings restatements in the US. The study examined whether the stock market reacts to restatements of earnings (usually restatements of the current year, or the previous one to three years). The authors provide evidence for a very strong correlation between restatements with past and current stock market reactions. Hence, Lev stressed that history is incredibly important in financial reporting and argued that the market is indeed interested in long-term patterns, i.e., whether a company is growing or declining.

Breu returned to the first of Lev’s suggestions, namely the proposal to quantify the impact of estimates on key numbers in the financial report. Though he argued that such disclosure would be too simple and carried little information, he agreed that disclosure on estimation processes, and the underlying assumptions of estimation, might have merit and should be debated further.

“There is no truth, there are no facts, but there are measurements of where the company is going.” Baruch Lev
Deterring Earnings Management: The Challenges – Facing Auditors and Financial Analysts

By providing an overview of the development in the audit industry, Paul Healy explained that the increase in competition in the audit field in the seventies led to cost cutting, lower fees and a big move into consulting. This, he claimed, created potential conflicts of interest. Additionally, the litigation risk for audit firms increased. Audit firms responded by standardizing their accounting and auditing standards, and implementing narrower, rule-based accounting rules. The client environment was changing faster than the ability of auditors to keep up. This problem exists in addition to the fact that auditors were trying to lower their cost structure.

Regarding the development of regulation, Healy questioned whether regulatory changes do indeed have an impact on the underlying economic problems within the audit industry. He claimed that the nature of accounting rules has not been addressed properly. Accounting standards have tended to be rule-based and focused on a mechanical appraisal of what facilitates the audit. Although the Sarbanes-Oxley Act claims to herald a return to principle-based rules, it remains unclear how this return will be achieved in practical terms.

Healy suggested that audit firms should review their audit business model and become more scrutinizing of their clients, especially risky clients. As the intermediary between investors and management, audit firms should provide additional services related to the audit in order to increase client value. As examples, Healy mentioned providing more informative (non-statutory) audit reporting, or providing fraud assessment. Audit firms should, on the other hand, reduce or eliminate non-audit work and focus on their core business.

With respect to accounting rules, auditors should support standards that enable professionals to exercise sound accounting and business judgement. Bright-line rules may be easy to audit, but they are certainly not value-enhancing from the standpoint of investors or managers.

The problem challenging sell-side analysts boils down to a funding problem and to conflicts of interest. The first problem has historically been solved by funding research through commissions. However, with the deregulation of commissions and new low-cost online trading platforms, it has become more difficult to fund research.

“For the audit industry and the analyst industry the regulatory reforms that were put in place didn't address the rootcauses of the problems.” Paul Healy
Funding research through investment banking results in a predictable conflict of interest. Healy has just completed a study (with Amanda Cowen and Boris Groysberg) looking at conflicts of interests among sell-side analysts. The authors investigated the bias in analysts’ earnings forecasts. Looking at two extreme models for funding research (a full-service investment bank, where the activities of the firm include investment banking and brokerage, and brokerage-only firms) and at the syndicate firms (distribution but no underwriting), the authors raised the question as to which analysts are the more optimistic. The results were surprising. Analysts from the brokerage firms tended to be the most optimistic, while the analysts from full-service banks were the least optimistic.

According to Healy, the fundamental challenge faced by the research industry is how research is to be funded. The challenge has not yet been addressed. Furthermore, Healy argued that large banks have been required to purchase research from independent third-parties, often brokerage firms. As a result, the largest investment banks, which tended to be least biased in the above mentioned study, have cut back on research. On the other hand, buy-side research has increased.

In another study (with Boris Groysberg, Craig Chapman, and Yang Gui), Healy compared buy-side to sell-side research by looking at differences in earnings forecasts. The authors show that buy-side analysts are relatively more optimistic and less accurate. When it came to recommendations, buy-side performance was terrible.

Healy concluded by raising some unresolved challenges: In particular, if the poor performance of the buy-side is the norm, how do buy-side firms improve research quality? Do we still need strong sell-side research? And finally, how should the latter be funded?
Earnings Management from a Legal Perspective  Hans Caspar von der Crone

The legal aspects of earnings management in Switzerland were presented by Hans Caspar von der Crone, who argued that strict accounting rules do not guarantee the prevention of fraud. Hence, he focused on the development of the institutional framework.

Von der Crone addressed developments in the audit field itself by pointing out that, due to recent revisions in Switzerland, it will be strengthened and the market will have more strict independence rules in fact and appearance.

Regarding the supervision of listed companies by the Swiss Stock Exchange (SWX), von der Crone explained that auditing firms of issuers must register with the admission board of the SWX. A panel of experts at the SWX examines issues of critical accounting questions. With respect to corporate governance, Switzerland introduced the Swiss Code of Best Practice (developed by economiesuisse) and the Directive on Transparency in Corporate Governance (established by the SWX), both effective since July 1st 2002.

Speaking about enforcement in Switzerland, von der Crone addressed the issue of compensation for damages, administrative penalties and criminal penalties. While there is a possibility of compensation for damages, individual investors do not have the possibility to sue the board based on contract, because there is no contractual relation between the individual investors and the board.

A violation of the duty of loyalty is not sufficient for the investor to make a claim against the company. There exists a certain concept of liability for breach of reliance. The courts, however, have been very reluctant to apply that to cases of missing market information, at least up until now. Cases lacking a violation of a criminal norm will not lead to a direct claim by the investor against the board of directors or the audit firm. It is, according to von der Crone, not trivial to deal with these issues on the basis of damages. He argued that some investors gain while others lose. Hence, he promoted the adoption of administrative penalties, such as sanctions imposed by the SWX.

Von der Crone concluded that it would be wrong to continue with plans to strengthen auditing standards. In his opinion, the current problem lies in their enforcement. In this regard, the necessary steps have been taken.
Whom Are You Fooling?  Paul Lee

Taking an investor's perspective, Paul Lee looked at recent practical examples, namely AIG and Rentokil.

He emphasized that he was not seeking to suggest that either company or its managers breached the law or relevant regulations or sought to fool the market. He wanted to advance the dialogue from a discussion of earnings management to what he called "management by earnings". Lee suggested that management by earnings is the precursor of earnings management and characterized it as focusing on "just the accounting numbers". According to Lee some companies display a shift towards management by earnings. This harms both the company and its investors.

Lee pointed out that business is inherently uncertain, and, naturally does not always display an upward trend. Yet, that is what some companies report over time. However, he suggested that eventually the market punishes those companies that fail to create long-term value. Hence, he concluded that a manager can fool the market some of the time, and sometimes they might even fool themselves. However, managers who have got used to the idea of management through earnings find that reality bites in the end.

Management by earnings can be as damaging as earnings management. According to Lee, the nature of the dialog on the debate between the market and companies must change. He recommended talking less about quarterly earnings and more about long-term value creation.
Panel Discussion: Consequences and Remedies – Striving for New Objectives

Rajna Gibson, Paul Healy, Frank Husemann, Paul Lee, Frank Schneider, Hans Caspar von der Crone

Further Thoughts on the Market’s Short-Termism

The ultimate objective of a company should be the maximization of long-term value, so the panelists. As discussed in the first panel, the debate about earnings management raises the question whether investors care about long-term value or whether they instead focus on short-term numbers. If we agree that there is a tendency towards short-termism, who should be in charge of changing the market’s mindset? Should the focus be on analysts, institutional investors or the companies themselves?

According to Lee, companies could be more proactive in addressing these issues. Changing the nature of the debate would force investors and particularly sell-side analysts to focus on the longer term. Clearly, institutional investors could also do more. The Enhanced Analytics Initiative, which aims to encourage better investment research, is a move in that direction and, according to Lee, a powerful message to the market.

However, there is also a sense in which some mechanisms of the market place drive people towards short-termism. Clearly, fund managers feel pressure to perform on a quarterly basis. There may be further steps to take, at various points along the institutional investor chain leading to the ultimate beneficiaries, in order to change the nature of the mandates given to various intermediaries.

Healey argued that when the market sees that a company’s long-term value is driven by long-term factors, investors are willing to give management discretionary power and do not exclusively judge on short-term earnings. In that sense, managers need to determine what drives the long-term value of their company and communicate that knowledge to the market. However, in the case of companies for which current performance is a good indicator of future value, quarterly performance is a good indicator for investors.

The Role of Executive Compensation

Market failures involve managers, accounting firms, and analysts. When talking about management, manager’s intentions play an important role. However, intentions are hard to assess, which
makes it necessary to look at incentives. Previous research has documented that managers rewarded with stock options have a higher incentive to commit fraud. Hence, the panel addressed the issue of management compensation. Gibson raised the question as to whether equity-based compensation should be limited and asked us to consider the role that the trend towards equity-based compensation might play in earnings management.

Healy emphasized that equity-based compensation has a positive impact on aligning managers’ interests more closely with shareholders’ interests. He expressed, however, concern about stock options as compensation, arguing that stock options are a very fragile approach to compensation. Once the options are out of the money, they no longer serve their positive intended purpose. Further, he expressed concern about the level of compensation. When rules regarding compensation transparency were implemented in specific countries, one might have expected managers to be a little ashamed about their earnings. This apparently did not turn out to be the case. The panel concluded that while the case for transparency in compensation was unclear, the magnitude of compensation was an area deserving further debate.

Huseman maintained that equity-based compensation is needed. He stressed that, currently, most CEOs and CFOs have very high fixed salaries in addition to their equity-linked compensation schemes. He did claim, however, that proper measurement of the individual contribution and performance of managers was missing. Von der Crone followed on from this by arguing that, if the exact performance of managers cannot be measured, then they should not be paid based on performance.

**Addressing Risk in Accounting**

With respect to accounting today, Gibson pointed out that there is a large debate on IFRS versus GAAP and what the proper accounting standards are. Finance addresses issues concerning performance and risk, but accounting does not address risk in the same way. Given that there are so many estimates in accounting, which are risky and uncertain, Gibson asked whether it would be appropriate to move towards risk accounting.

The panel members agreed that risk should be addressed in corporate disclosure, meaning it would be good to use disclosure as a means to provide information on risk. Lev argued that accounting, as a somewhat primitive system, does not rely on risk measures. However, managers say a lot about risk and provide an overflow of information about it. What is needed in financial reporting, he argued, is not further talk about risk, but rather, instituting risk measures.

**The Funding of Research**

The final issue addressed by the panel concerned the funding of research. The question was raised whether it would be appropriate to remunerate analysts based on the risk-adjusted performance of their recommendations.

Healy explained that buy-side analysts are evaluated and rewarded on the basis of their performance and their recommendations. In terms of sell-side analysts, Healy pointed out that institutional investors claim not to pay much attention to recommendations from sell-side analysts. What they are interested in is the description of the industry and the economics of the business.
Markus Huppenbauer rounded off the conference by presenting thoughts on earnings management from an ethical perspective and by addressing the question of whether, and how, moral standards can be implemented in business.

Huppenbauer made clear that ethics should be part of a company’s strategy and that acting according to moral standards ought to pay off in the long run. Naturally, a company’s first priority is its survival and the optimization of profits in a sustainable fashion. Huppenbauer argued that ethics could be implemented under these conditions, for example by producing ethical goods. He further emphasized that companies tend to voluntarily adopt moral behavior when they face the risk of a loss to their reputation for not maintaining ethical standards. However, if respecting and implementing moral standards leads to competitive disadvantages, ethics will not establish itself.

The requirements for a suitable economic and legal framework are that it must ensure that even an immoral person can conform to moral standards; incentives favoring the implementation of moral standards have to be created. Yet, economic incentives can fail, and the regulation of moral and ethical behavior can easily result in overregulation, with the risk of certain disadvantages such as inefficiency and barriers to innovation.

Furthermore, companies as well as individuals need some flexibility and the implementation of moral standards must be complemented with considerations of individual morality. Hence, Huppenbauer addressed the question as to which character traits should be promoted in business executives. Huppenbauer emphasized that in finance, core values such as trustworthiness, truthfulness, honesty, and independence cannot be established exclusively by economic means within the company, or by the legal incentives to avoid penalty. The moral integrity of managers provides a foundation to a company’s values and its corresponding willingness to act. This basis can then be drawn upon in a multitude of situations.
Marc Chesney is Professor of Finance at the University of Zurich. He has published several articles and books in the area of quantitative finance. He has begun to focus on the subject of ethics and finance. In addition, he is an external expert with the World Bank.

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Conference Organization: Marc Chesney, Rajna Gibson, Christine Hirszowicz, Carsten Murawski, Alexander Seidler.
Printers: Casanova Druck und Verlag AG, Chur.

Copies of the booklet are available from NCCR FINRISK, Plattenstrasse 14, 8032 Zurich, Switzerland, Fax +41 44 634 4903, Email: ethicalfinance@nccr-finrisk.ch. It can be downloaded at www.nccr-finrisk.ch/ethicalfinance/.