Deterring Earnings Management: Challenges Facing Auditors & Analysts

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Financial system overview
Audit industry challenges
Financial analyst industry challenges
Impact of regulatory responses?
Outstanding challenges?
The capital market: a system of checks and balances

Information Demand Side

- Retail Investors
- Professional Investors
- Analysts

Information Supply Side

- Board & AC
- Managers
- Auditors

Investment advice
Financial statements & business information

Standard Setters, Capital Market Regulators, Courts
Yet … recent system problems

- Fraud and scandal
  - Worldcom
  - Enron
- Earnings management
  - Record # restatements
- Over-investment in firms with flawed business models
  - Dot.com
  - Telecom
So …

- Why did this happen despite very sophisticated information and intermediation infrastructure?
  - Few bad apples?
  - Systemic problems?
- Issues facing two key players:
  - Auditors
  - Financial analysts
Forces affecting audit industry

- Competitive environment
  - Mid-70s - pressure to increase competition
  - Impact
    - Cost cutting – erosion of staff quality
    - Pressure to acquire and retain clients
    - Consulting - potential conflicts and loss of focus

- Litigation environment
  - Mid-70s - Fraud on the Market Theory
  - Impact
    - Mechanical accounting & auditing standards
    - Narrow rule-based focus
Forces affecting audit industry

- Client business environment
  - Increasingly complex
    - New complex securities
    - New complex business relations - challenging entity concept
    - Mark to market accounting
  - Impact
    - Audit firms lacked business expertise - narrow accounting training
    - Financial engineering outpacing accounting expertise

Compliant and rule-oriented auditors
Is SOX answer?

- Positives
  - Audit committee oversight – potential for more independent, higher quality audits
  - CEO and CFO incentives more aligned with auditors
  - Audit firms required to refocus on core business
  - Independent oversight of audit firms

- BUT does it address other issues?
  - Economics of the industry and attracting talent
  - Nature of accounting rules
What can audit firms do?

- Review audit business model
  - Number and type of clients?
  - Expand scope of work
    - More informative (non-statutory) audit report?
    - Fraud assessment?
  - Improve risk management and pricing
  - Attract, train & retain talent
  - Reduce/eliminate non-audit work
- Standard setting advocacy
  - Support for standards that enable professionals to exercise sound accounting & business judgment
Sell-side analyst challenges

- Funding research
  - Difficult for investors to capitalize on research
  - Trading commission funding
    - Deregulation of commissions
    - Rise of low-cost online trading platforms
  - Investment banking funding
- Conflicts of interest
  - Investment banking
  - Trading
Which analysts are most biased?

![Bar chart showing analyst forecast optimism for different types of financial analysts. The chart includes bars for Full Service Banks, Syndicate Firms, and Brokerage Firms across various metrics: ST EPS, MT EPS, LT EPS, and Target Price. The bars indicate the degree of optimism in analysts' forecasts.]

Source: Cowen, Groysberg, and Healy (2005)
Additional findings

- Bulge analysts least optimistic
- Retail/institutional brokerage analysts more optimistic than pure institutional brokerage
- Coverage decisions by brokerage analysts partially explain optimism
- Brokerage bias unaffected by stock market crash

Source: Cowen, Groysberg, and Healy (2005)
Global Settlement: is it the answer?

- Separate investment banking and research
  - But how to fund research?
- Require large banks to purchase research from independent third parties
  - But these firms often brokerage firms
  - Will they improve research quality?
- Effects on research
  - Cut-backs by bulge banks
  - Increase in buy-side research
Is buy-side research answer?

- Money management firms able to
  - Profit from equity research
  - Internalize research costs
- Implications
  - Research more efficiently funded through buy-side
  - Retail investors should delegate investment decisions to professionals
But, how good is buy-side research?

- Study of analysts at top 10 money management firm vs sell-side
- Earnings forecasts
  - More optimistic
  - Less accurate
- Less profitable recommendations
- Sell-side analysts switching to buy-side firm
  - Forecast and recommendation performance deteriorates after switch

Source: Groysberg, Healy, Chapman & Gui (2005)
Outstanding questions

- Is poor performance of buy-side firm norm or exception?
- If so, how do buy-side firms improve research quality?
- Do we still need strong sell-side research?
- If so, how will it be funded?
  - Investors - purchase as stand-alone product?
Conclusions

- Financial system complex network of relationships
  - Piece-meal reforms less likely to be effective
- Regulatory reforms imperfect
  - Provide penalties for violators
  - May resolve some problems
  - But do not always address root causes
- Unresolved challenges
  - How to improve economics of audit industry?
  - How to fund market research?