

Business Education and Corporate Accounting Scandals: Lessons on Accounting Information and Investor Trust

*Bala G. Dharan**

1. INTRODUCTION

The Enron failure and other spectacular corporate accounting and governance scandals of recent years have several important lessons for what we need to teach in the classroom and how we should integrate the material across different subjects, such as finance, accounting, law, and ethics. No one is holding the business schools responsible for the dramatic failings of their students who starred in these corporate scandals—not yet, anyway. For every scandal-tainted MBA, one could point to hundreds of other business leaders who are contributing positively to society as good citizens and achievers. But this does not mean that educators should escape without any blame either.

The early reaction of business school professors to the scandals has been to use the scandals enthusiastically as classroom material to supplement whatever is normally taught in the class, or to even offer specific new courses to cover all aspects of the scandals—courses that are marketed as “all Enron, all the time.” The scandals have become popular “case studies” for class use in courses such as accounting, auditing, corporate finance, investment banking, business strategy, ethics, and so on. However, as we assimilate the scandals into our case lore, academics need to also ask whether the scandals point to any fundamental problems or weaknesses in the structure of our curriculum and in the way we approach the teaching of fundamental concepts in business. If so, merely including case studies and reading about the scandals in existing classes will not serve as an adequate response to the scandals. Assuming that structural reforms in business curriculum are needed, we will need to address them aggressively and soon, so that future business leaders do not get drawn into the same kinds of business situations and decisions that characterize the current scandals.

* J. Howard Creekmore Professor of Accounting, Jesse H. Jones Graduate School of Management, Rice University, Houston.

By curriculum structure, I mean both what is taught in a given course or class and how the different courses are integrated together over the course of the degree program or study plan to achieve the desired goals of education. Curriculum design issues are almost always complex and hard to tackle in a university because they bring up questions about how professors will work together to deliver the desired learning objectives of the school. Surprisingly, pedagogical concepts such as “integrating across courses” are hard to adopt, for most professors. Professors are more used to specializing in one subject and teaching it well in a classroom, and they usually do not want to be bothered with what is taught in other courses. Compounding this notion of specialization, business school faculty members are generally organized in a strict departmental structure. Professors are generally assigned to a department that is their home base for everything—from recruiting to promotion, course allocations, budgets, etc. As a result, curriculum design exercises often turn out to be political land mines. Faculty members may try to defend a particular curriculum issue, with the knowledge that changes may mean some departments winning (and others losing) faculty positions (the ability to hire more faculty members) and budgets. Nevertheless, curriculum changes do take place, albeit infrequently.

The magnitude of investor losses and the complexity of management fraud seen in recent scandals suggest that it may indeed be time to get prepared for one of these infrequent curriculum battles. The scandals and the resulting stock market losses show that there was a huge failure of understanding the important informational role of financial accounting disclosures among corporate managers, their accounting counterparts, the internal control people, the corporate counsel and legal support, and the top management and the board. Such a large-scale abuse of accounting systems, and the corresponding failure of so many business disciplines to understand the role of accounting in our capital markets, clearly suggests the possibility of fundamental flaws in how each of these disciplines approaches its role relative to the corporation and each of the other disciplines. If so, solutions to the crisis must involve not only regulatory reforms and changes in governance procedures, but also reforms and revisions to the system of training and education of managers that might have led so many managers and accountants to abuse the principles of accounting. This in turn suggests the need for us to reexamine business curriculum issues to prevent repeats of the scandals.

2. INVESTOR TRUST AND THE INFORMATIONAL ROLE OF ACCOUNTING

While the typical corporate structure of separation of powers among competing units obviously provides for several built-in conflicts among the units, the potential conflicts between accounting and non-accounting functional areas are especially important for our purpose, since it is accounting’s historical role as neutral and objective recorders and transmitters of information that was most likely compromised in Enron and all of the other recent scandal-ridden companies. At the core of these conflicts is a failure by managers to grasp the critical role of accounting disclosures in building and maintaining investor trust, and the equally critical role of investor trust in a company’s ability to raise capital and survive as a corporation.

Public companies and public capital markets exist only because investors believe that financial disclosures produced by a company's management are trustworthy. Since investors cannot personally monitor a corporate board or management's decisions, they rely entirely on the financial statements and other financial disclosures from the company to verify that their investments are safeguarded and, more important, to monitor and interpret the future economic prospects of the company. Despite advances in communications, including the advent of the Internet, the fact remains that there is simply no substitute for formal financial reports when it comes to providing reliable and trustworthy information to investors. Company managers are not expected to just use public forums, such as media appearance, webcasts, or press releases, to communicate financial data to investors. These alternative sources of information can and do coexist with accounting disclosures, but investors and regulators have come to regard financial accounting reports produced by company management as the primary source of verifiable and reliable information about a company. Thus, in modern capital markets, investor trust is entirely determined by the ability of corporate financial statements being perceived as neutral and objective while providing useful and timely information. Once accounting information is suspected of not having these fundamental characteristics, public capital market participants have no choice but flee to the exit doors.

It is important to distinguish between what accounting can do and cannot do for a company. Good accounting is not a substitute for a poor business model. Customers of a company do not necessarily read financial reports before buying the products and services. A company must still need to have a well-defined business purpose, a clearly articulated business strategy, products and services that are desired by customers and which can be made and delivered profitably, and effective management to develop and execute strategy. Having reliable financial reporting will not prevent a company from failing if its basic business model and execution are weak. However, as a conveyer of trustworthy and useful information to investors, accounting can and does affect a public company's very existence. While a failure of a business strategy can hurt a company, companies do routinely fix business problems and go on to achieve success. However, failure of accounting to fulfill its role as producer and conveyer of trustworthy and useful information can doom a public company to bankruptcy by shutting down all routes of access to capital markets for the company's financial needs.

Modern industrial societies understand this critical do-or-die role of accounting information for the existence of well-functioning capital markets and public companies. Since trust in financial information is so critical, the United States and most other major countries have developed over the years several layers of corporate governance and regulations to reinforce the system of trust. These layers include requiring audits of financial reports by external auditors, having regulatory systems to monitor and regulate the external auditors, requiring adherence to formal accounting and disclosure standards developed by independent external organizations, such as the Financial Accounting Standards Board ("FASB"), and enforcing the accounting standards and disclosure rules through governmental agencies such as the Securities and Exchange

Commission ("SEC"). Other corporate governance requirements, such as board audit committees consisting of independent directors, and regulatory provisions, such as oversight by stock exchanges, are intended to further strengthen the disclosure system's trustworthiness. But at the core of the entire system of disclosures is the trust placed by investors that corporate management will provide them with reliable and useful information about the company's operations.

3. PRESSURE FOR EARNINGS MANAGEMENT

Corporate managers who fail to grasp the critical role of accounting information in keeping investor trust (or fail to understand the importance of this trust in accessing capital markets) are likely to end up treating the accounting function as just another unit of the corporation to be deployed and managed for shareholder value maximization. This, in turn, will very likely lead to business situations where managers have the temptation to compromise the fundamental informational role of accounting and destroy the desired qualities of accounting information, namely its reliability and investor-relevance, in favor of other corporate objectives of the moment. Managers trying to meet any number of legitimate corporate goals, such as sales targets, cost targets, analysts' earnings expectations, and bonus plan targets, or who are trying to make critical investment and financing decisions to achieve these targets, can suddenly find accounting rules and systems standing in their way. If corporate managers do not understand that even "temporary" compromises of the accounting rules and systems can lead to a deadly loss of investor trust, then there is nothing to stop the pressure on a cost center—such as accounting—to acquiesce and move out of the way.

There is some evidence that, over the past two decades, companies have shifted away from treating accounting as a desirable independent function, and have instead restructured the accounting operations in ways that put internal accounting processes squarely in the way of other competing corporate goals. For example, several studies of Enron's internal control failures have discussed the inherent conflicts that arose every day between the risk assessment and control ("RAC") division of Enron, charged with measuring and monitoring corporate-wide risk and given the power to reject risky projects, and the managers, who were trying to get their projects approved. On the one hand, given the deal-making culture prevalent in the company, operating managers were provided incentives to be dealmakers and were rewarded with large bonuses only when their projects were approved. On the other hand, not only were there no incentives or bonuses for the RAC managers when projects were rejected, the RAC managers were also reporting to senior management, who also benefited with large bonuses when projects were approved by the RAC.

Faced with pressures to cut costs and outsource non-essential functions, corporate managers have resorted to cutting down or even gutting groups such as accounting, which are often viewed by senior managers as non-revenue producing "cost-centers." Accounting managers (controllers, chief accounting officers, etc.) have increasingly been relegated to less visible roles within companies, and their functions are viewed

mainly as a non-essential data-processing field that can be outsourced if necessary, rather than as a critical link in the communication chain between the company and investors. Not surprisingly, this has led to more frequent pressures on the accounting system to manage earnings and other disclosures for the purpose of other desired corporate purposes.

4. LESSONS FOR EDUCATING MANAGERS

This discussion of the changing role of corporate accounting suggests that an environment for earnings management is now pervasive in modern corporations. As earnings management escalates, there is an increased risk that the critical informational qualities of accounting reports, including neutrality, objectivity, and informational relevance, will be compromised. Our current regulatory responses to the recent corporate scandals, such as the passage of the Sarbanes-Oxley Act and the creation of the Public Company Accounting Oversight Board (“PCAOB”), have focused mainly on strengthening the systems of checks and balances, especially the corporate board and the external audit functions. However, these measures, while necessary and important, do not address the fundamental structural issues within corporations discussed here—issues that pit accounting against other business functions and create pressures from line managers on accountants to massage the accounting numbers. In addition to the new regulatory changes in auditing and improvements in corporate governance system, we need to also examine how managers are currently educated in business schools about the role of accounting information and consider whether the current business curriculum perhaps reinforces and supports the confrontational environment between managers and accounting that exist in many companies.

We will start with possible problems and needed changes in the way that accounting and finance are taught in business schools. It makes sense to focus on these two subjects first because almost all of the controversial areas of earnings management and accounting abuse in the past three decades have taken place in areas where line management crosses paths with financial accounting and reporting. These intersections include leases, derivatives, consolidation, mergers and acquisitions, pensions, securitization of assets, vendor financing, barter transactions, and convertible debt.

Consider leases as an example. Managers have several incentives to push leases off balance sheet, and this has led to several decades of battles between the accounting profession and corporate management. After more than a decade of debates and inaction in the 1960s, the accounting profession finally passed a rule (FASB Statement No. 13) in 1977 to force the capitalization of certain leases and to put them on balance sheets as assets and liabilities. However, management intent on keeping leases off balance sheet soon responded with dozens of loophole-exploiting implementation tricks. The last twenty-five years have seen a continuing battle between the FASB and the corporate finance world on this issue. Despite the active pursuit of loopholes by the FASB, the net result of the lease accounting battles is that most companies that do not wish to report leases on balance sheets manage to achieve that objective today. For

example, according to the 2002 annual report of Delta Airlines, it has only \$127 million of leases reported as capital leases, on the balance sheet, representing the present value of about \$172 million of payments over the next several years. But the footnotes reveal that an additional \$12,744 million of future lease payments are classified as operating leases and are not listed on the balance sheets. In other words, the liabilities representing about 98.7 percent of all future lease payments are kept off balance sheet by the company.

The lease accounting battles were just a precursor to the much larger accounting battles that have followed during the 1980s and 1990s in the areas of acquisition accounting, consolidation of off-balance-sheet entities, derivatives accounting, and accounting for stock options. All of these areas involve corporate management goals that potentially conflict directly with accounting's need to report neutral, objective, and useful information to investors. In acquisition accounting, companies invented the pooling method of accounting instead of using the traditional purchase accounting to keep goodwill and other intangible assets off balance sheet, thereby understating the actual future reported costs of acquisitions (represented by goodwill amortization and other depreciation charges). Attempts by the FASB to restrict the use of the pooling method did not prevent the method from becoming the preferred way to structure merger transactions during the stock market boom of the late 1990s. In a related area, companies trying to keep whole groups of assets off balance sheet have run straight into traditional accounting concepts of entity and consolidation, and have resorted to creative techniques to skirt the consolidation rules. In the case of Enron, this led to the creation of thousands of so-called special purpose entities ("SPEs"). In the stock options area, corporate management wanted to benefit from the incentivizing effect of granting stock options to their employees (and to themselves) but did not want to show the effective cost of the options in their income statements. Finally, in the growing field of risk management and derivatives, corporate managements that are trying to adopt innovative financial products (ones that try to bridge the gap between liabilities and equities) have generally come to perceive the traditional accounting rules that make a fundamental distinction between contingent liabilities, liabilities, and equity as major impediments.

An examination of the financial reporting problems in these so-called financial engineering areas shows that, in many cases, the auditors and accountants struggling to come up with appropriate accounting rules for a given financial situation are not really aware of the history of the controversy in that area, or of the powerful motivations of managers to skirt existing accounting rules. From an educator's point of view, the problem can be traced back to the compartmentalized way that business courses, such as accounting, finance, and strategy, are taught in most business schools. As a result, students, who are really future business managers, are rarely exposed in the classroom to the potential conflicts between the objectives of corporate management (such as financial engineering) and the objectives of corporate accounting.

To illustrate the types of changes that would need to be made in business school teaching, look at the way that accounting is currently taught in many business schools.

(Of course, a similar detailed analysis of curricula should be done for other areas, such as finance, strategy, and ethics.) Consistent with the traditional focus of accounting on collecting and recording data and producing financial reports, accounting courses in business schools have emphasized a rules-based and transaction-oriented approach to teaching business applications of accounting. For example, in the case of lease accounting, students might learn how to record business transactions related to leases from a lessee's and lessor's point of view, what the rules are for classifying leases as capital leases or operating leases, how lease assets and obligations are estimated in the case of capitalized leases, how the lease payment can be separated into principal and interest, how gains or losses are recognized in a sale-leaseback situation, and how synthetic leases can be reported. What is most clearly missing in this list of learning objectives is getting an appreciation for the business contexts in which lease accounting conflicts between managers and accountants arise.

Other courses, such as finance, do, of course, take up the specific business contexts in which leasing decisions may occur. However, the learning objectives in these courses are usually not designed to use or even complement what has already been taught in accounting. For example, in finance classes, the focus of class discussion is primarily the valuation role of cash flows. The essence of modern corporate finance courses is that only cash flows matter for valuation. To the extent that accounting is perceived as relevant in this approach, the focus is on the deconstruction of accounting data for the construction of cash flows. For example, depreciation, an accounting concept, is introduced in finance classes solely to calculate its "tax-shield" benefit (arising from the tax deductibility of depreciation) and the resulting incremental cash flows, and not for any other informational role that depreciation expense may play in measuring income or investment returns. Similarly, students rarely are given an opportunity to think about the informational role of lease accounting information, such as the effect of reporting lease liabilities on the balance sheet and the corresponding effect on the stock market's perception of the company's risk and the reliability of its information.

In fact, it is not uncommon to find, in popular finance textbooks, statements that categorically dismiss accounting rules and accounting-based financial statements (particularly the income statement) as irrelevant for corporate finance and valuation except for the help they provide in the computation of cash flows. Consider, for example, how a popular finance textbook,¹ widely used in many MBA programs, introduces and explains the purpose of accounting and accounting reports and their uses in finance.

- **Finance is on top, and accounting reports to it:** "In large firms, finance activity is usually associated with a top officer of the firm, such as the vice president and chief financial officer, and some lesser officers. . . . Reporting to the chief financial officer are the treasurer and the controller. . . . The

¹ STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD, & JEFFREY JAFFE, *CORPORATE FINANCE* (6th ed. 2002).

controller handles the accounting function, which includes taxes, cost and financial accounting, and information systems.”² (Note the subservience of the accounting function to corporate finance, and the lack of mention of the accounting function’s role in producing information for investors.)

- **Conflict between accounting rules and corporate goals:** “By generally accepted accounting principles (GAAP), the sale [on credit] is recorded even though the customer has yet to pay. . . . From an accounting perspective [the company] seems to be profitable. However, the perspective of corporate finance is different. It focuses on cash flows. . . . Value creation depends on cash flows.”³ (Note how the old accounting concept of revenue recognition is dismissed.)
- **Questionable use of financial statements for finance:** “Chapter 2 describes the basic accounting statements used for reporting corporate activity. . . . It will become obvious to you in the next several chapters that knowing how to determine cash flow [from the financial statements] helps the financial manager make better decisions.”⁴
- **The value-irrelevance of the balance sheet:** “Many users of financial statements, including managers and investors, want to know the value of the firm, not its cost. This is not found on the balance sheet. In fact, many of the true resources of the firm do not appear on the balance sheet. . . .”⁵ (Interestingly, even as finance books dismiss the balance sheet as value-irrelevant, finance researchers increasingly are elevating the book value information from the balance sheet to a central role in risk measurement and asset pricing models.)

One could go on. There are dozens more of similar quotes questioning the validity, purpose, and usefulness of financial reports and accounting information. The income statement gets a special trashing.

The purpose here is not to criticize this one book. A cursory examination of any top-selling finance textbook will show a similar sprinkling of statements that often reflect a basic lack of understanding of the critical role of accounting in measuring corporate performance and conveying it to investors in a neutral, believable way. Without meaning to do so, the finance courses start off by, effectively, questioning the very purpose of preparing financial reports using accounting concepts that have been developed over centuries. Rather than trying to help the student understand and integrate the objectives of accounting and finance, the net effect is to paint a corporate picture that dismisses the role of accounting managers as trivial, secondary, and even disruptive to value-creation, even as finance managers nobly try to maximize corpo-

² *Id.* at 5.

³ *Id.* at 7.

⁴ *Id.* at 22.

⁵ *Id.* at 24.

rate value. The student, who may have just come off four months of an accounting course, is left wondering if it was all just a waste of time and tuition dollars.

To summarize, compartmentalized teaching of accounting and finance does not achieve the goal of helping the student learn the business contexts in which financial decisions are made as well as helping the student to understand the importance of measuring and conveying the financial information to market participants. The current failure of accounting education to help students understand the finance and business contexts in which accounting transactions take place has led to the training of primarily rule-oriented accountants. Not surprisingly, these transaction-oriented accountants are quickly sidelined in the corporate world, as the decision-makers try to "get the deals done." The lack of a principles-based learning approach and the lack of mastery of the modern business decision contexts have also led to a generation of auditors who focus more on the strict application of rules rather than on the relevance of the resulting data to decision-makers, such as investors and creditors.

5. CONCLUSION—THE GOOD NEWS

One way to measure the flexible response of a profession to structural changes is to examine the number and variety of new courses offered by the area's faculty over time. On this, the news on the accounting front does not appear encouraging. The bulk of financial accounting courses offered in most business school still consists of introductory accounting, intermediate accounting, advanced accounting, and financial statement analysis, along with a smattering of other traditional courses, such as accounting theory and international accounting. A visitor from the 1950s would find the order of the accounting courses in the curriculum, and often the content, familiar and unchanged. However, despite this appearance of no change, many positive changes are indeed occurring under the surface in many business schools. The good news is that many accounting and business programs nationwide are starting to recognize the shortcomings in business education that arise from the compartmentalized teaching of critical business concepts. For example, a monograph published by the American Accounting Association⁶ helped to bring to the attention of academic accountants the need to improve accounting education and to integrate the teaching of critical business concepts in accounting courses. In particular, it effectively addressed the issue of developing a principles-based learning program. This study does not, however, discuss the inherent conflict environment that exists in the corporate world between accounting and other functions or the way in which the compartmentalized teaching of accounting and finance, among others, helps to reinforce these conflicts. As all business areas start to focus on the critical role of accounting reports in an information society and on the need for reliable information to run businesses, it is hoped that further efforts for improvements in business education across several fronts will follow.

⁶ W. Steve Albrecht and Robert J. Sack, *Accounting Education: Charting the Course through a Perilous Future*, 16 ACCOUNTING EDUCATION SERIES (American Accounting Association 2000).

