“Doing God’s work?”

AUTHORS
Ehsan H. Feroz

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Ehsan H. Feroz (USA)
Doing God’s work?

Abstract
This is an instructional-aid designed to highlight the basic differences between cash and accrual basis of accounting. It alerts the readers of financial statements to the murky areas of accrual accounting required by both the US Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS). It is presented for a wider audience with little or no accounting background.

Keywords: accrual, cash, FASB (Financial Accounting Standards Board), GAAP, GAAS (Generally Accepted Auditing Standards), IASB (International Accounting Standards Board), IFRS.

The characters mentioned here are all fictitious and have no relationship whatsoever with any real life entities or individuals vaguely resembling them. The setting is a café not too far away from the Wall Street.

Ms. Cash: What is this talk in town about bank barons and gold sacks?

Mr. Accrual: Oh, it’s a big fuss for no-nothing which will die down after sometime. Folks on the Capitol Hill simply do not appreciate what a fine job we do as professionals. We do God’s work! The problem is people on the main street do not understand the fine art of accrual accounting.

Ms. Cash: Fine art?

Mr. Accrual: Yes, accrual accounting is one of the finest games in town ever since Pacioli.

Ms. Cash: Pacioli?

Mr. Accrual: Oh yes, it’s the Italian monk who invented the juggling game called double-entry but was not smart enough to patent it so that he could ask for a share of Figlio Berlusconi’s fortune today. Too bad, he did not live long enough to see how smart managers like Mad Hoff play the game and earn sainthood in the Accounting Hall of Defame.

Ms. Cash: How do you play this accrual game anyway?

Mr. Accrual: Well, it’s a balancing game with some fuzzy rules called GAAP manufactured by a little factory down in Norwalk, CT (FASB) which allows you some discretion to accrue or not to accrue certain events (transactions) and disclose or not to disclose certain entities. They are even talking about outsourcing it to an overseas location in London, UK (IASB)!

Ms. Cash: Accrue or not to accrue? To be or not to be! I am a bit puzzled since in my world things are rather cut and dry. Either you have cash in your till or you don’t.

Mr. Accrual: Yes, GAAP is a fine veil to cover a lot of Russian poker faces. Rev. Omar did not quite invent the burka (veil), but he knew how to use it against Nicholas Sarkouzi’s clamors for full-disclosure. The problem is the more you unveil (disclose) the higher the scrutiny by big bully (SEC)!

Ms. Cash: What is this fuss about full-disclosure?

Mr. Accrual: Never mind, you are supposed to disclose only material items.

Ms. Cash: Material?

Mr. Accrual: Yes, I mean materiality is one of the finest disclaimers of this juggling game.

Ms. Cash: Tell me about this ‘entity’ business.

Mr. Accrual: See we exercise due-diligence in not mixing up things that belong to Cesar’s entity with those of Pope’s entity. Sometimes though it’s possible under limited but well defined circumstances to rob Peter through inter-company transactions to give to Paul!

Ms. Cash: You are going a little too fast for me. But how do you learn to play this juggling game called accrual?

Mr. Accrual: Well, you can start with a self-help guide like Accounting for Dummies or you can go to a college and pay hefty fees for diplomas in shrink wraps. What can you learn from nerdy professors earning peanuts! But if you really want to be good at it, you need to have an articulated clerkship with pros like Artamus Johnny Anderson.

Ms. Cash: What does Anderson teach you?

Mr. Accrual: You learn a lot from pros like Anderson such as the magic of accrual, science of GAAS and the fine art of shredding.

Ms. Cash: You mean the culinary art of shredding Swiss cheese?
Mr. Accrual: Oh, no. I meant shredding relevant documents.

Ms. Cash: Relevant, another jargon?

Mr. Accrual: Yes, another fine tool in the Accrual Hall of Fame.

Ms. Cash: How do you know what is relevant?

Mr. Accrual: Well, it takes a lot of practice! Relevance is in the eyes of the beholder. Years of apprenticeship is the only sure fire way to know what is relevant and what is not. Even then it is a matter of judgment!

Ms. Cash: What is this other term, GAS?

Mr. Accrual: It’s GAAS not GAS. It’s another set of fine tools in the accrual armory reserved as a shield for crusaders in any potential battle against infidels who don’t have meaningful jobs except to waste our tax dollars overseeing us. What can overseers (SEC) oversee since there is so much to unveil by managers? Fox Harry Potter Pit guarding the henhouse of naïve investors!

Ms. Cash: I guess, I am ready for a drink.

Mr. Accrual: Let’s go. I assure you, things will be a lot more transparent after a drink of vodka!

The End

Pedagogical note

This case has been student-tested by the author and other colleagues for introductory accounting and finance classes. In an ideal setting, two students typically role-play Ms. Cash and Mr. Accrual. Managerial role-playing as an instructional device has been used by the author quite effectively for both introductory and upper division classes. While the case is suitable for almost any accounting and finance course in any sequence, it is best to use the case at the beginning of the semester when the instructor is highlighting the differences between cash and accrual basis of accounting for prospective managers. The following questions (Q) and suggested answers (A) may be used to reinforce the basic points of the case.

Q1. Who invented the double entry bookkeeping?

A. Luca Pacioli is generally credited with the invention of double-entry bookkeeping.

Q2. What are the basic differences between cash and accrual basis of accounting?

A. The basic difference between the cash basis and accrual basis of accounting is in terms of level of complexities and degree of managerial discretion in determining reported performance in financial statements. Cash basis of accounting is easier to understand and easier to explain to investors. One of the key assumptions of accrual accounting is that accounts receivables will eventually be realized into cash. Whether this particular assumption is tenable, if so, under what circumstances, and with what level of confidence, is really the essence of accrual accounting. While both accrual and cash basis of accounting provide opportunities for manipulation by managers, the level of fuzziness and complexity of accrual accounting oftentimes makes managerial manipulations much harder to detect. There are layers of judgment and decisions in accrual accounting that need be debunked before one can say conclusively or even tentatively that the management manipulated the numbers.

Q3. What role managerial discretion plays in accrual accounting?

A. Accrual accounting (GAAP or IFRS) can be broadly defined as the sum of discretionary and non-discretionary managerial accruals and deferrals. Judgment by managers plays a significant role in accrual accounting. While both the US GAAP and IFRS allow for considerable discretionary accruals, at times aggressive managers can push the limits of discretion to the frontier where an outsider might interpret that discretion as being fraudulent or unethical (Feroz, Park and Pastena, 1991).

Auditors are supposed to be vigilant against fraudulent misstatements by managers especially, since the preparation of financial statements is the responsibility of the management, and not those of auditors. Despite the enhanced level of ‘due diligence’ because of the Sarbanes Oxley Act of 2002, the auditors cannot guarantee against managerial fraud given the very competitive audit market, and the current statistical sampling based auditing regime.

Q4. What role monitoring plays in accrual accounting?

A. A carefully designed system of checks and balances such as an adequate system of internal control, independent outside auditors, and enforcement agencies such as the US Securities and Exchange Commission (SEC) are essential to the success of an accrual regime. When these internal and external regulatory checks and balances are bypassed either because of an authoritarian CEO who is also the Chairman of the Board, or misalignment of incentives of the auditor and the audit committee, accrual accounting can turn into a huge mess to be ferreted out by naive or even so-called sophisticated investors.

Q5. Can an efficient stock market see through the managerial accounting gimmicks?

A. In the 1970s and 1980s many finance and accounting academics argued that the efficient stock
market can see through and debunk any potential foul play by skilful and unethical use of discretionary accruals by managers (Fama, 1970). In the wake of the stock market crash of 1987, some accounting and finance academics were ready to challenge the very strong form of the efficient market hypothesis. Recent revelations by managers who systematically fooled the market for quite sometime until the unethical managerial practices and the real financial health of the company became public, certainly raise further doubts as to whether the so called ‘informed investors’ can really see through the accrual accounting gimmicks the way the proponents of the strong efficient market hypothesis would like to make us believe they do.

One can also raise questions as to whether the analysts such as those with the Moody’s recently investigation by the SEC, have the incentives to share their in-house assessment with the market in the way that the proponents of the strong form of efficient market hypothesis have so far assumed they (analysts) do.

Endnote

This paper is dedicated to the memory of late Professor Abraham Briloff who documented many loopholes of US GAAP through his brilliant exposes in the Barron’s (Alpert, 2013). An earlier version of this case was presented before the Annual Meetings of the American Accounting Association, 2003.

References