Do Annual Reports Present the Real Picture?

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"We have audited the accompanying financial statements of …………Ltd. ("the Company"), which comprise the Balance Sheet as at 31st March…………, the Statement of Profit and Loss and the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information.

In our **opinion** and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the (Companies) Act in the manner so required and give a **true and fair view** in conformity with the accounting principles generally accepted in India:

(a) In the case of the Balance Sheet, of the state of affairs of the Company as at 31st March………;

(b) In the case of the Statement of Profit and Loss, of the profit of the Company for the year ended on that date; and

(c) In the case of the Cash Flow Statement, of the cash flows of the Company for the year ended on that date."

This is the solemn opinion expressed by the company auditors in India and elsewhere on similar lines on its annual financial statements. This opinion leads the stakeholders to believe that annual reports present a real picture of the financial position and performance of a company. But **do annual reports really present the real picture**? The answer is **'Yes'** as well as **'No'.**

And when the answer is **'No'** the results can be disastrous far beyond one's imagination. Website www.accounting-degree.org presents an interesting infographic '**10 Worst Corporate Accounting Scandals of All Time'** perpetrated during the last decade-and-a-half. A summarized version of the infographic is presented hereunder.

Sl. No.	Name of corporate concerned	Nature of Scandal	Main perpetrators	Modus-operandi
1.	Satyam computers (2009)	Falsely boosted revenue by **$ 1.5 billion.**	Founder chairman Ramlinga Raju	Falsified revenues, margins and cash balances to the extent of 50 billion Rupees.
2.	Bernard L. Madoff Investment (2008)	Tricked investors out of **$ 64.8 billion** through the largest Ponzi scheme ever.	Bernie Madoff, his accountant David friehling & Frank Dipascalli	Investors were paid returns out of their own money or that of other investors rather than profits.
3.	Lehman Brothers (2008)	Hid over **$ 50 billion** in loans disguised as sales.	Lehman executives and auditors Ernst & Young.	Sold toxic assets to Cayman Island banks with the understanding that they would be bought back eventually. Created the impression that the company had $ 50 billion more cash and less of toxic assets to that extent.
4.	AIG Insurance (2005)	Massive accounting fraud to the tune of **$3.9 billion** was alleged, along with bid-rigging and stock price manipulation.	CEO Hank Greenberg	Booked loans taken as revenue, steered clients to insurers with whom AIG had payoff agreements, and told traders to inflate AIG stock price.
5	Freddie Mac (2003)	**$5 billion** in earnings were misstated.	President/COO David Glenn, Chairman/CEO Leland Brendsel, ex-CFO Vaughn Clarke, former senior VPs Robert Dean and Nazir Dossani	Intentionally misstated and understated earnings on the books

6	HealthSouth (2003)	Earnings numbers were allegedly inflated **$1.4 billion** to meet stockholder expectations.	CEO Richard Scrushy	Told underlings to make up numbers and transactions from 1996-2003.
7	Tyco (2002)	CEO and CFO stole **$150 million** and inflated company income by **$500 million.**	CEO Dennis Kozlowski and former CFO Mark Swartz	Siphoned money through unapproved loans and fraudulent stock sales. Money was smuggled out of company disguised as executive bonuses or benefits.
8	WorldCom (2002)	Inflated assets by as much as **$11 billion**, leading to **$180 billion** in losses for investors.	CEO Bernie Ebbers	Underreported line costs by capitalizing rather than expensing and inflated revenues with fake accounting entries.
9	Enron (2001)	Shareholders lost **$74 billion,** thousands of employees and investors lost their retirement accounts.	CEO Jeff Skilling and former CEO Ken Lay	Kept huge debts off balance sheets.
10	Waste Management (1998)	Reported **$1.7 billion** in fake earnings	Founder/CEO/Chairman Dean L. Buntrock and other top executives; Arthur Andersen Company (auditors)	The company allegedly falsely increased the depreciation time length for their property, plant and equipment on the balance sheets.

These were all blue chip companies widely acclaimed for their professional management and investor friendliness until the related scams were unfolded. These scams resulted into settlements, running in to billions of $, of shareholder class-action suits, SEC fines, institutional investors' claims and bankruptcies which costed thousands of jobs, shaking of faith in the corporate structures of listed entities and eventually the infamous US financial crisis of 2008 in the aftermath of Lehman Brothers scandal.

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These scandals were uncovered, in many cases, by SEC investigations and by new management team, internal whistle-blower (Enron), company's internal audit team (WorldCom), SEC suspicions and confession (Satyam) in other cases.

It needs to be appreciated that within weeks of the WorldCom scandal unfolded, the US Congress passed the landmark Sarbanes-Oxley Act introducing the mandatory corporate governance mechanism for listed entities. One of the key objectives of the act was to ensure disciplined accounting and financial disclosures. Still 6 catastrophic accounting scandals were unearthed in the US between 2002 (Tyco) and 2008 (Lehman Brothers and Bernard L. Madoff). Does it mean that corporate governance mechanism has failed to deliver its objectives?

Common to all of these scandals is the fact that they were perpetrated by the top management functionaries in control of their respective companies. In many cases auditors have also been alleged to have connived with the top management.

Even in cases where the auditors did not connive with the management, are they not guilty of negligence in the discharge of their audit function? Anyone having even little knowledge of accounting and auditing, if looks at the modus-operandi column in the above table, will vouch that all the transactions involving the scandals are duly verifiable with reference to the documentary evidence. This verification, particularly in large material transactions involving mind boggling billions of $, is a specific function of the audit plan of the auditors of a company. How could the statutory auditors justify non-detection of these frauds? The non-detection becomes more questionable in view of the continuous internal audit of the companies that too under the charge of independent audit committees. Clearly the internal auditors also failed in the discharge of their duty. The fact remains that these frauds were not just one time affair. They were being perpetrated for number of years before they were detected. The auditors must therefore accept the responsibility for such frauds without taking recourse to technicalities of the scope of audit function.

Finally in view of the above discussion, the following steps can be taken to minimize occurrence of such frauds and to reasonably assure that the annual reports present the true picture:

1. Auditors and audit committees should be directly held accountable for accounting scandals.
2. Early warning signals based on quantitative data may be developed to prevent accounting scandals. The government, accounting profession and academia may join hands for the purpose.
3. A regular system of financial investigations by the Financial Reporting Authority of India may be devised whereby each listed company is subjected to annual/periodical investigation by rotation.

Above all, the problem is deep rooted in the human greed and characterlessness and therefore no effort can prevent financial frauds until those at the helm of affairs discharge there responsibility with a spirit of trusteeship and high character. The solution to this financial problem actually lies in this non-financial realization. Then only the annual reports will present the real picture.