Ethics in Financial Analysis: Battlefield of Principles

Cristina Drumea
"Transilvania" University of Brasov
cristina.drumea@unitbv.ro

Abstract

The paper discusses the way in which creative accounting practices and subsequent financial audit and analysis transform the economic environment leading to cascade crises, to proliferation of ill-practices and to violating ethic principles in the hope of a swift cash-out from volatile situations. Recent decades' financial crises are discussed in relation to an increasingly controlled financial services market, while financial scandals keep on overflowing despite the over-regulation worldwide. Ethical behaviour of the main actors involved is disbalanced by quick profit enticement, which calls for stronger regulatory measures, in many legislators' opinion, or for lesser intervention in the hope of a self-regulation under the law of supply and demand of financial services.

Key words: Creative Accounting, Financial Ethics, SOX Standard
J.E.L. classification: M42, M48, G01, G38, H32

1. Introduction

Nowadays economic reality often presents operational decisions and erroneous strategic positionings related to controversial accounting reporting by major companies or other important economic actors. Most of these decisions based on the results of economic and financial analyses conducted by competent teams, being less influenced by the emotional-intuitive approaches of key decision makers. In the same family of analytical instrumental failures, we can include the low predictability of negative economic shock-events. It would be sufficient to remember the persistence of questions about the "surprising" 2008 financial crisis and the criticisms manifested by the decision makers towards economists in regard to its unpredictability. In this context, it is justified to have a deeper look at how an economic analytical tool relates to an expected positive result and can or cannot respond correctly to the current society's expectations.

A first issue is discussing how to combine a technical measuring instrument, bearing objective and quantitative characteristics to ethics in general, and to the ethical principles of our present time as long as a quantitative element (analysis) is thus associated with a pronounced qualitative one (ethics). As a rule, the use of an analytical tool which presents a realistic view on the reality that is observed can be discussed through ethical compass mainly at times when it is considered that its use was inappropriate. The implicit assumption is that use itself is ethical, but occasionally unethical results have been generated by the particularities of the case.

Considering both these types of failure and the current ethical standards associated with the business world, we consider that starting the discussion by scrutinizing the analytical instrument itself and its usage in second range seems to be a more comprehensive approach. In addition, the approach is less ambiguous than the one that is limited only to the mode of use, possibly through a case study.

For the financial analysis as a tool to measure the economic performance of an organization, especially a profit-oriented one, the last decades have marked enough events (Enron, Lehman Brothers to cite only the most famous ones) raising questions about its ethics.

A collateral "event" of a theoretical nature was the development of the CSR (Corporate Social responsibility) concept. The latter has reset talks about business' goals and the ethics of the profit maximization. In fact, there has been an important trend in how to redefine business and use certain management tools, including financial analysis.

2. Literature review

Financial analysis is an instrument designed to help improve the way an organization meets the purpose for which it was created. If the organization is a profit-oriented entity, the analysis would improve the organizational behaviour adopted to maximize profits through the information it synthesizes in diagnostics. This role of financial analysis for this type of organizational structure is built on the assumption that a company's rationality is of an economic nature. With this hypothesis, another set of assumptions about relationships between people and the behaviour of the corporation is validated, based on current theories and accumulated practice, including by reference to the moral and ethical system of nowadays society founded on a capitalist approach and development.

Assuming in this general context that the company is established for economic purposes, it is necessary to identify their characteristics as well as their beneficiaries. In other words, it is necessary to identify the characteristics of the "good" pursued by the company and who are those who perceive these "good" deeds. The impact of the tool should then be assessed both in identifying this "optimum" and in shaping the behaviour of prospective beneficiaries in its search. Without looking for references in the classical works of old and new Marxists, the discussion about the "good" of a company at the moment, carried with the generic reference concepts, means to counterpart the interests of shareholders with those of the stakeholders. In essence, two relatively opposite approaches, theorized by Friedman (1970) and Freeman (1984), would counterbalance. In other words, shareholder vs. stakeholder means Friedman vs Freeman. The way in which it is considered ethical to move the balance towards one of the two sides will finally define the ethical context of using the financial analysis.

Friedman (1970) considers that a business has no social goals, but only the responsibility of profit. On this fundament, all its actions are designed to satisfy the interests of the shareholders, and maximizing profits is the essence of the actions taken by the company in which the latter share an interest. The consequence is that the financial analysis, calibrated on the optimization of the results that are currently used on the stock exchange analysis is an ethical tool because its unanimously accepted goal is pursued according to the ethics of the capitalist economy.

In a financial analysis, tracking profitability is the action of maximum interest. Dilemmas arise about the way in which profitability is synthesized in different indicators, but also about the way profitability truly reflects the firm's well-being.

Profitability indicators are known by the three-letter acronyms used on stock exchanges: ROA, ROI, EPS, and ROE. The EVA (Economic Value Added) and MVA (Market Value Added) metrics, which are supposed to reflect market opinion, were added almost half a century ago. Positive appreciations (Skyrme and Amidon, 1997) are counterbalanced by Goldberg (2000), which claims that these indicators generate illusions. Theoretical disputes remain current, illusions continue to be created and drive markets, and smaller or larger falls continue to appear "surprisingly." To what extent the creation of illusions is ethical, as well as the mechanism associated with the appreciation of "added value", remains to be debated.

The way in which profitability reflects the company's wellbeing also remains in debate. Undoubtedly, the approach that focuses on the interests of shareholders is preserved, even if the perception of the market is discussed as alternative, which would also infer the interests of other stakeholders. As a principle, it is worth noting that the company's wellbeing does not necessarily mean the shareholders' wellbeing. In order for them to fulfil their desired level of security, they will modulate the business, meaning they will tend to shape the company's relationship with other companies, along with moulding the organization's behaviour toward maximizing their own profit. This structure shaping may translate in practice into including the company in a holding and/or operating with off-shore companies located in fiscal paradises. In addition, profit optimization is also made by choosing a convenient operating formula between parent and subsidiaries in other countries, especially in emerging economies.

The clearest consequences fall into two categories of voluntarily diminishing the profits of a company operating in economies with high taxation. The first category consists of diminishing the profit of the parent company by operating in conjunction with offshore firms in tax havens. Examples of famous companies (Deutsche Bank, Societé Générale) or names in more than 100 states associated with the notorious "Panama Papers" investigation line are already part of the literature and of the recent past and practice. Additionally, it is worth mentioning the case of General Electric, a corporation celebrated for corporate governance innovations, who had years (2008 to 2016) [https://itep.org/wp-content/uploads/35percentfullreport.pdf accessed 27 May 2019] of reporting zero profit in US after transferring its fruitful activity results to offshore subsidiaries. The same was reported about other giants of the US economy (Apple, Microsoft, Oracle and Google), who rounded up the top 20 companies with the biggest cash in offshores in 2016.

Similar situations are reported in the EU: "The European Commission expects more than 6,000 multinational companies to be affected. It estimates that the EU, which is composed of 28-member countries, is losing as much as 70 billion euros ($ 80 billion) a year because of corporate tax avoidance. [Https://money.cnn.com/2016/04/12/news/tax-europe-companies-eu/index.html?iid=EL consulted on 21 May 2019] The second category is represented by the subsidiaries located in emerging economies that report, on average, less important profitability rates as compared to the local companies, including the public ones. The reason is the transfer of profit to areas with more favourable fiscal policy, following shareholders' interests.

Besides shaping the company’s relationship with its economic environment, using the holding/grouping principle as a tool, its "borders" can be transformed by the A & M (Acquisitions and Mergers) approach. Essentially end in reference to the financial analysis tool, it is noteworthy that its results can be carved according to the stakeholders’ temporarily “fashionable” illusions - using the same A & M policy.

The specific economic literature notes that US companies were hit in the 1980s and 1990s by what was called a merger-mania especially in sectors such as Telecommunications, commercial Banking, Aerospace and Pharmaceuticals. Of course, a significant part was due to a defragmentation tendency in the sense of increasing the influence of the resulting colossus on the market and its associated benefit range. In other situations, however, in order to improve the financial analysis figures in the chosen market sense of the moment, the companies grew affected by a fever of acquisitions and mergers. Long-term results were poor, but immediate ones - reflected in outstanding outcomes revealed by diagnoses and financial reports - gave satisfaction to those directly involved as initiators. This is the case for a number of CEOs who have been trained on the wave of financial wizards, ignoring the product, technical innovation and longevity of the firm in its economic environment.

It should also be noted that the profit reporting discussion is inextricably linked to a standardized 1-year financial interval, which is likely to significantly distort a rational behaviour that targets the wellbeing of a company over a time frame that should not be linked to the power arrangements of the executives or the transitorily interests of the shareholders, but to the logic of the product(s) and of the respective business.

In summary, the financial analysis is intended to be an objective tool to optimize the economic behaviour of a company for the benefit of its shareholders primarily. This optimization occurs under the caveat that the entity is demarcated by its executives who tend to create through financial reporting the illusion of a positive development as compared to the epicentre, possibly using financial and fiscal malpractice in the other countries in which it operates. Reactions by the governments of these countries are increasingly punitive, even though the list of such countries includes the world's champion of economic liberalism or the EU member States.

Freeman (1984) has launched the idea that the company should take into consideration the interests of its stakeholders in a balanced way. In practice, this would mean pursuing a series of performance criteria other than purely financial ones. These criteria may intend to support the interests of stakeholders other than the shareholders. In this way, the ethical impact of a tool that absolutizes interest in financial performance is basically diminished, but it is implicitly recognized that it would generate an ethical issue by stimulating selfish behaviour and greed, to the detriment of social orientation and even to the detriment of the true and fair view accounting principle. It should be noted that Freeman does not discuss in terms of clarifying the financial analysis ethics but moves the scope from profitability to other measurable criteria that should be considered relevant to the success of a business.

The introduction of quantifiable and difficultly manageable criteria (Holbrook, 1999 and Priem, 2007) does not simplify the ethics of using financial analysis, however it provides an elegant solution to avoid a corrosive discussion that undermines a tool with satisfactory outcomes.

3. Research methodology

As essential as it is, ethics is a non-quantifiable element that through its nature cannot be controlled at every junction. Legislation can though be modified in order to alter the effects of non-compliance to ethics codes, which for a given economic environment can be reassuring in theory but quite extraneous in practice.

The research hypothesis we start from is that financial services sophistication comes along with the corporations' inclination to avoid rules and regulations and to slide in the grey zones that insure better returns despite of risks.

Second hypothesis is that governments' tendency is to over-regulate the financial services field (audit, accounting, financial analysis, diagnosis, banking services etc.) in a strive to combat the creative accounting practices on one side (ref. to US Sarbanes-Oxley Act of 2002) and the formation of shadow banking structures on the other side (ref. to EU Regulation No. 2365 /2015 on transparency of securities financing transactions and reuse and amending EU Regulation No 648/2012).

Several famous cases are discussed and inter-linked in order to depict an economic reality of the 2007-2008 and earlier financial crises, with a focus on the governance's legislatives responses and their effects over the sanity of the financial world.

4. Findings on financial analysis ethics

Considering the general question of the relevance of a company's financial results for the "good" of its stakeholders, the assessment of the usage of financial analysis is rigorously required, because its misuse can only amplify doubtful approaches as discussed above. Assuming, however, that the prior principal issues are maintained in an acceptability zone, usage of financial analysis tools would theoretically reveal two possibilities of introducing negative impact elements.

The first possibility would be to introduce erroneous data in the decision-making process due to malfunctioning but unintentional use of the analysis tool. The optimistic variant would be the occurrence of errors due to the lack of knowledge of the field of financial analysis and/or the related rules or even due to the occurrence of material errors, in the sense used in legal procedures. The situation seems to be plausible for small and medium-sized companies, and for example, tax authorities in Romania have begun to consider this possibility of unintended error. Even if the accounting documents have to be certified by authorized personnel, the unintentional error is possible and reasonable.

The second possibility and the really damning one would be to deliberately generate errors or to use procedures that speculate grey areas at the limit of regulations. Economic dictionaries have introduced the term of "misleading financial analysis". It is defined as "Financial analysis of an organization is misleading when it is used to misrepresent the organization, its situation or its prospects"[English Encyclopaedia]. It also explains that it is used to mislead investors by creating market bubbles. The topic of financial analysis ethics is part of the financial ethics.

Obviously mal-intended use takes many and diverse forms and contradicts the current ethical norms of the capital world in the developed countries. For example, a private organization interested in this field - the Seven Pillars Institute for Global Finance and Ethics - uses a collection of over 100 cases to discuss and illustrate the issues and themes related to this topic. In other words, forms of business ethics violation under the umbrella of figures of financial significance, forms embodied in notorious cases (e.g. Deutsche Bank) or involving well-known names such as that of President Trump as a businessman, are numerous. However, those who escape academic analyses or judicial establishments are probably more numerous and are already using banalized recipes due to their frequent use.

Discussions about use and spread of creative practices in the financial statements identify three primary reasons for it:

1. A link of embellished financial results with the executives' benefits,
2. The freedom of interpretation that the Financial Accounting Standards Board (FASB) allows for, *and*

3. The concentration of accounting, auditing, and diagnosis services into huge companies (in the US especially, with reference to the Big Four group).

If in the first two causes the logic of the process is clear, concentration of the accounting services offer generates a more sophisticated response. Simplifying, one can say that a big accounting firm is required to provide a pink image of the financial situation in order to keep that client satisfied and willing to (over) pay for these services (Anton, 2011).

The "classic" area of accounting creativity in the sense depicted above has its peak in the invasive scheme for generating a market bubble. From the manipulative recipes, in a relatively logical way in the mentioned context of the three cases, an equally “creative” approach of the use of the financial analysis has been reached. Although these approaches can be considered defensive and tracking local effects at the level of one company, the "wave" can generate negative effects across an entire industry. Implicitly, it generates a devastating effect on the reputation of the sector/auditing profession and, more generally, on the credibility of an instrument that is claimed to be objective, such as financial analysis.

The major shock associated with the audit and consultancy sector became prominent in 2001 at the collapse of the energy giant, Enron. This was a Texan corporation well-known for its expansive behaviour and the relatively persuasive organizational culture associated with its business success. The audit firm that testified Enron's success was the famous Arthur Anderson, one of the "big Five" accounting firms that dominated the American market at the time and became legendary worldwide. Arthur Anderson has endorsed the "creative" recording practices of the Enron client. Essentially, they presented positive financial results, although the situation was unfavourable to that extent that in 2001 the company went bankrupt. Given the gap between the real situation and the audit outcome, Arthur Anderson was found guilty of criminal charges in 2002 and voluntarily surrendered license. Even though in 2005 the Supreme Court cleansed Arthur Anderson due to procedural errors of the first instance court in 2002, the case remained emblematic for the misappropriation of financial analysis and the name Arthur Anderson disappeared from the accounting services market by reducing the circle of the auditing companies’ elite from Big Five to Big Four.

Without neglecting the implicit ethics signals given by the court judgments, it is worth noting that the market has reacted by generating consistent discussions on audit ethics and related financial analysis. Similar scandals involving emblematic firms on the American market of the same period, Tyco or WorldCom were added to the Enron case. The negative consequences of bankruptcies and financial malpractice have been perceived not only by shareholders, but also by many stakeholders: employees, participants to pension funds, suppliers, local communities, etc. Their dissatisfaction got politically aggregated and materialized the ethics signal in a regulation issued in 2002, the Sarbanes-Oxley Act. The Act enter in effect since then and was no longer influenced by the 2005 Supreme Court ruling on Arthur Anderson, which shows that the ethical "defect" perceived by the public was set straight by new anti-fraud legislation, and not by a post-factum punishing intervention, based on the previous legislation.

This regulation was intended to emphasize pressure towards standardized use of financial analysis and its tools, in order to limit "creativity" in the field, and to reduce the number of cases with negative consequences across a country's economy. The tendency towards standardization has become increasingly clear, and in practice national standards and IFRS international standards have been set up for the European area. Their effect seems to have been positive in its initial stages of implementation, yet the number of financial scandals remains significant (Drumea, 2008).

In terms of financial sector sanity and for the business world, much more severe were the shocks created by banks, leading to the 2008 crisis. In some situations, as in the cases of PNP Paribas in early crisis 2007 or the famous Lehman Brothers in the September 2008 crisis, their effects have generated major global issues.

Although for a crisis of this magnitude some general pre-conditions are necessary, as in questionable practices supported by a large number of organizations, the prompting role belongs only to a restraint number of companies or a minor number of decision-makers (Bacanu, 2016). In the most recent subprime crisis, the role of trigger is attributable to the American banks. More specifically, the 2008 crisis, which was fuelled by the housing boom in the United States, was triggered by an unregulated shadow banking system that has grown out of proportion and overtaking the traditional banking sector in size. Most of these institutions did not fall under the supervision of the Federal Reserve at the time (Keats, 2015). The ultimate point of origin of the great financial crisis of 2007-2009 can be traced back to an extremely indebted US economy. [...] Accounting data fail to reveal the full extent of the financial maelstrom. Ironically, according to these data, US banks appear to be still adequately capitalized (Fratianni and Marchionne, 2009).

5. Conclusions

The discussion on ethics in financial analysis reveals an annular, self-destructing structure: the economic context is distorted by ethically questionable practices under the grey zones of rules and regulations, which calls for actions from the legislator. However, the existing distortions already generate further tools and procedures that stimulate unethical approaches in direct relation with the initial intention to positively impact the context. Which one triggered the other? The dilemma …

Over-regulating the relations between companies in a given economic context, as well as focusing on the shareholders' interests associated with annual profit can constitute prerequisites for misleading financial analysis. It comes from a natural behaviour of the main actors seeking the best outcome of a situation and is to be expected. What are the correct answers to this form of normality? All regulatory attempts have triggered more sophistication on the faultier side, with no concrete and long-terms effects on the sanity of the context.

In the depicted economic torments, the reaction is to discuss about the technical triggers and the solutions allowing to shift the situation back to the positive coordinates before the crisis. The general context is less discussed, nor the direct reference to ethics. In the case of the most recent 2007-2008 crisis, it has not been analysed to what extent the "unregulated shadow banking system" is ethical or an "extremely indebted economy" is likely to generate a framework that favours sustainable unethical behaviours rather than sustainable economic development. In other words, while we make the same errors, it is very likely that we will obtain the same doubtful results.

6. References

- Anton, C.E., 2011. Considerations related to the taxation–accounting connection, reflected in the collaboration between the romanian companies providing financial–accounting services and their clients. In *INTED2011 Proceedings*, pp. 1330-1339.
- Bacanu, B., 2016, *Anti-strategic Management: teorie și studii de caz*, Polirom, Iasi.
- Berle, A.A., Means, G.C., 1932, *The Modern and Private Property*, Transactions Publishers, New Bwick, NJ.
- Drumea, C., 2008, Rules on business ethics. Sox standard. *The Amfiteatru Economic Journal*, 23, pp.155-160.
- Ehrbar, A., 1999. Using EVA to Measure Performance and Assess Strategy", *Strategy & Leadership*, vol. 27, nr. 3, pp.20 – 24.
- Fratianni, M.and Marchionne, F., 2009. The Role of Banks in the Subprime Financial Crisis, *Review of Economic Conditions in Italy*, 2009/1
- Fratianni, M. and Marchionne, F. 2010. The Banking Bailout of the Subprime Crisis: Size and Effects, *PSL Quarterly Review*, Vol. 63, No. 254, pp. 185-231.
- Freeman, R.E., 1984, *Strategic Management: A Stakeholder Approach*, Pitman, Boston, MA.
- Friedman, M., 1970. The Social Responsibility of Business is to increase its Profits, *New York Times Magazine*, Sept.13, pp. 32-33, 122-126.
- Gardner, M., McIntyre, R.S., Phillips, R. 2017. The 35 Percent Corporate Tax Myth CorporateTax Avoidance by Fortune 500 Companies, 2008 to 2015, Report by Institute on Taxation and Economic Policy (ITEP).
- Goldenberg, D.I., 2000. Shareholder Value Debunked, *Strategy & Leadership*, vol. 28, nr. 1, pp.30 – 36.
- Grubb, Th. M., Lamb, R., 2000, *Capitalize on Merger Chaos: Six Ways to Profit from Your Competitors' Consolidation and Your Own*, the Free Press, NY.
- Holbrook, M.B., 1999, *Consumer Value: A Framework for Analysis and Research*, Routledge, London

- Keats, R., 2015. US Banks Played a Pivotal Role in the 2008 Financial Crisis, [online] Avaliable at https://articles2.marketrealist.com/2015/11/us-banks-played-pivotal-role-2008-financial-crisis/ [Accessed 16 May 2019]
- Lehn*, K.,* Makhija, A.K., 1996. EVA & MVA as Performance Measures and Signals for Strategic Change", *Strategy & Leadership*, vol. 24, nr. 3, pp.34-38.
- Priem, R.L., 2007. A Consumer Perspective on Value Creation, *Academy of Management Review,* vol. 32, nr. 1, pp.219–235.
- Skyrme, D.J., Amidon, D., 1997. The Knowledge Agenda, *Journal of Knowledge Management*, Vol. 1 Issue: 1, pp.27-37, [online] Available at https://doi.org/10.1108/13673279710800709 [Accessed 15 May 2019]
- Skyrme, D.J., Amidon, D.M., 1998. New Measures for Success, *Journal of Business Strategy*, vol. 19, nr. 1, pp. 20-24.