Funding the Future

Discounting is open to abuse in financial reporting - w...

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I read with interest an article by Prof Adam Leaver of Sheffield University published by Open Democracy yesterday. I should, stress, Adam and I do know each other: we are in fact bidding for two grants together right now (which does not mean we will get them).

Adam has done a lot of work looking at outsourcing. In the article he looks at how Interserve, which has now failed, paid management bonuses on the basis of re-stating profits in ways wholly inconsistent with the accounts of that company, triggering liability for massive payments to directors when the company was facing insolvency. The whole article is worth reading, but I highlight this comment from Adam's conclusion:

Interserve is an allegory for late capitalism's dysfunctions, where capturing gatekeeper positions inside a firm rather than generating real value drives economic outcomes and inequality.

And I also pick up one of his diagrams, which was in this instance appropriately offered by Interserve auditors KPMG on where the audit risk they faced was located, in their opinion. It shows this:

Note what is in the top right-hand corner, where risk is greatest. It is all the areas where discounting can most readily influence income recognition. In the light of my recent comments on this blog on the dangers arising from the use of this technique in accounting I am amused by this confirmation from an unexpected source of what I have been saying. The faux science of discounting is not science when it comes to financial reporting. It is instead in far too many cases bogus cover for management judgement used to smooth earnings to suit management purposes, with that judgement used to reward a few at cost to the many involved in any company.

I do not dispute the value of discounting at the right time and in the right place. For investment appraisal if you wish; for internal contract accounting if you desire; for estimating cost when making funding decisions, and so on. It has a role. But the wrong tool used in the wrong place creates the opportunity for abuse and alternatives to discounting are available in financial reporting, and those alternatives that offer greater degrees of certainty with no less accuracy (and all financial reporting involves trade-offs between these qualities). In that case the alternatives should be used, precisely to thwart management who might otherwise be tempted to abuse, which no one can afford.