Detecting Earnings Management
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measurement changes, ordinary cyclical strength in the economy, increased investment, and specific productivity gains in the technology sector itself. As to the last point, New Economy skeptics question whether a computer factory truly doubles productivity by boosting the processor speed and memory of its product by 100 percent, because most users will not take full advantage of this increased computing power.

Calverley's balanced critique of the New Economy is consistent with the nondogmatic, commonsense tone that he maintains throughout his book. For example, he discusses recent economic history in classic business-cycle terms but warns of the practical difficulty of generating excess returns by spotting turning points and adjusting asset allocations accordingly. Similarly, Calverley details the merits of monetarism but also endorses economists' pragmatic approach of considering money supply only together with other indicators.

Although he avoids ideological extremes, Calverley is not afraid to dispute conventional wisdom. For instance, he argues that removal of Japan's trade barriers would not necessarily reduce the country's trade surplus. Imports would rise, but unless the nation's traditional excess of savings over investment also disappeared, the yen would cheapen and Japan's exports would rise to offset the increase in imports. "A paradox is therefore that the U.S. companies who urge an opening up to more imports might be shocked to discover that the relative competitiveness of Japan actually improves as a result."

In the 1999 Federal Reserve Bank of Dallas annual report, President McAteer described himself as a country boy, for whom "paradigm" is a pretty fancy word. As if to buttress that self-assessment, he lists a first-time visit to the Grand Ole Opry among his personal high points of 1999. Even if McTeer were really as economically unsophisticated as his "aw, shucks" style suggests, he would have little difficulty grasping either Alcaly's or Calverley's judgments regarding his beloved new paradigm. The two authors reviewed here reach contrasting conclusions, but they both provide straightforward, reasonable advice on handicapping future economic performance and gauging its implications for investment returns.

—M.S.F

Notes

1. *The New Paradigm*. 1999 Annual Report, Federal Reserve Bank of Dallas: www.dallasfed.org/fed/annual/1999p/ar99.pdf.

Detecting Earnings Management. **By Gary Giroux. John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, 201–748–6011. 326 pages, $51.95.**

Reviewed by Michael A. Martorelli, CFA.

Following sensational financial reporting scandals at companies such as Enron Corporation, WorldCom, and Adelphia Communications, authors with varying backgrounds began, predictably, to publish their versions of "how could this have happened?" and "how can we predict when it will happen again?" Among the many resulting volumes, *Detecting Earnings Management* should be one with a long-lasting influence on practitioners and students of financial accounting.

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Author Gary Giroux is Shelton Professor of Accounting at Texas A&M University. His department had close ties with Arthur Andersen's Houston office and was active in examining the Enron disaster's probable impact on the accounting profession. Giroux personally took on the task of determining how such a scandal could occur. After all, as he notes in the preface, the U.S. financial reporting system is highly regulated. Moreover, investors have access to a seemingly unlimited amount of financial data. *Detecting Earnings Management* is the result of Giroux's research into "figuring it out." His goal is to provide a rigorous framework for analysis that will help readers both to understand the environment in which earnings management exists and to evaluate the financial and nonfinancial signals that might alert them to future debacles.

Unlike such authors as Howard Schilit (*Financial Shenanigans*) and Charles Mulford and Eugene Comiskey (*The Financial Numbers Game*), Giroux defines "earnings management" as a neutral term,

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not a pejorative one. In the first few pages of text, he explains his notion of the four-phase continuum of accounting judgment—from "conservative accounting" at one extreme to "financial fraud" at the other. In separate appendixes, he documents the various definitions of earnings management used by accounting professionals and academic researchers. Among the many references cited at the end of the book are certain articles suggesting that investors reward earnings management and others differentiating good earnings management techniques from bad ones.

After putting his stake in the definitional ground, Giroux describes the environment in which earnings management may occur and discusses the interests and roles of both management and outside advisors in promoting or condoning earnings management. His baseline considerations for the analysis of a corporation's financial statements and nonfinancial disclosures set the tone for the detailed analyses that follow. Unlike other authors of books on similar topics, he emphasizes the need for a comprehensive strategy for earnings management detection that involves the interrelationships among all financial and nonfinancial documents.

Giroux provides thorough analyses of (1) earnings management potential and (2) earnings management detection strategies involving various line items on a company's financial statements. In separate chapters, he discusses each major financial statement and a nonfinancial disclosure statement, such as the proxy statement. For added perspective, he includes a separate chapter on trend analysis, industry norms, and quarterly filings. This section, which is clearly designed for use as a supplemental text in a financial analysis course, includes end-of-chapter problems, cases, and appendixes. These teaching tools involving real companies and industry sectors are designed to translate generic detection strategies into specific findings. Even practitioners not interested in reexamining the minutiae of accounting should find most of the material useful.

Turning to business combinations, Giroux expresses satisfaction with the Financial Accounting Standards Board's elimination of the pooling-of-interest accounting method, which step has somewhat simplified the financial analysis of acquisitions. He notes with frustration, however, the variability that still exists in (1) allocating the purchase price to appropriate assets, (2) establishing goodwill and considering subsequent impairment charges, and (3) dealing with the issue of materiality. Giroux lists specific concerns that should be addressed at the acquisition announcement date and following consummation of the transaction. He also offers earnings management detection strategies for use in evaluating minority equity investments, divestitures, and spin-offs.

An impressive feat is that Giroux's chapter on derivatives and special-purpose entities is as clearly written as the rest of the book, which renders this subject easy for a practitioner to grasp. Most of the recent scandals involved hidden financial risks and exposures related to complex corporate relationships and ventures. Even when such relationships were disclosed, they were described only in convoluted legal and accounting language. Giroux quotes chapter and verse on the companies' opaque verbiage in his examples and end-of chapter problems. Whatever happened, one wonders, to the U.S. SEC requirement for the use of "plain language" in corporate filings?

In summary, the book's goal of uncovering potential financial chicanery is laudable, and the author should be applauded for his critical analysis of numerous nonfinancial disclosures as well as all financial line items. Readers must beware, however, of seeing conscious earnings management in every use of judgment in a financial reporting policy. Accounting purists with imperfect knowledge of certain businesses must resist the temptation to detect a nefarious intention behind every discretionary accounting decision.

Notwithstanding this caveat, *Detecting Earnings Management* provides a genuinely useful roadmap for approaching answers to "how could this have happened?" and "how can we predict when it will happen again?" Each chapter includes several well-designed tables. Indeed, one could create a handy reference tool by cutting and pasting together a packet of about two dozen of these tables for day-to-day use. Giroux also provides a fascinating review of more than 100 years of accounting scandals. A companion appendix provides similar details about the history of accounting and financial regulation in the United States.

In the sea of books on accounting problems, analysts' shortcomings, and do-it-yourself financial analysis tools, this one stands out. Its ultimate success, however, will depend largely on the willingness of financial analysts to incorporate Giroux's ideas and his framework for analysis in their daily routines.

—M.A.M.

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