Madura, Jeff – What Every Investor Needs to Know About Accounting Fraud

McGraw-Hill, *2004, [Equity Investing]* Grade ★★

Reading this book I went from mildly pleased, to incurious and finally downright irritated. The subtitle is "*Proven Techniques to Avoid Questionable Stocks*". In reality Jeff Madura, a finance professor at Florida Atlantic University and an author of several finance textbooks, provides nothing of the kind in this book written after the Enron and WorldCom scandals burst in the early 2000s.

The author has divided the text in 5 different parts and the book starts off by displaying a number of ways that companies historically have used to look more profitable - by increasing sales alternatively decreasing costs - or look more financially stable than they actually were and Madura clarifies with some of the then recent examples from the bust after the TMT-bubble. It is fairly basic but illuminating and written in good spirit. It's an okay introduction to the subject of financial deception.

In the next chapter Madura tries to explain why so few have the ability but more importantly the incentive to uncover the shenanigans. The short answer is that they are all on the payroll of the corporations who cheat. Auditors are paid by the companies and apart from doing audits earn money on doing extra corporate consulting. The firms that Wall-Street analysts work for earn the big bucks from corporate finance services for the companies and the analysts are dependent on the goodwill of the companies for their flow of information. Credit rating agencies depend on the audited accounts prepared by the auditors who are on the take. This was prior to the debacles of the rating agencies in the GFC so the fact that companies pay for the rating agencies' ratings as well isn't discussed. Still the bottom line is that no one wants to bite the hand that feeds them.

Then follows two sections on how board practices should serve the owners of the companies and governmental regulatory initiatives and bodies related to financial supervision. These sections are fairly basic (SEC should get more resources), they have a kind of academic ivory tower touch to them (FASB should be allowed to write really detailed accounting rules), also they are a bit dull and don't really speak to the investor who wants to understand how to protect himself from investing in the wrong kind of stocks.

The last part is called "*How Investors Can Cope With Deceptive Accounting*" and at last we should presumably in the six chapters that follow learn how to "protect your investing portfolio from accounting fraud". I expected some discussion on how to use financial tools like cash conversion, change in accruals, change in Days Sales Outstanding, Days Sales in Inventory or other less frequently used metrics perhaps in combination with other more subtle signs of ethical collapse in companies.

One of the chapters can be summed up with that the reader shouldn't trust anyone. This is a rather superfluous message since it has to a large extent been the overall message so far. However, Madura now also adds that the reader shouldn't even trust his own ability to uncover financial tricksters. Consequently the advice in three of the other chapters is "give up"! Invest in mutual funds, ETFs, T-bills and bonds instead of individual stocks. Talk about a let down! Yes, by investing in bonds the investor clearly "avoids questionable stocks" but that was probably not quite the type of advice that people expected to get and what got them interested in purchasing the book.

In all honesty there are two other chapters that look into investing in stocks. The author advices the reader to look for corporate management teams that run their companies for the long term and to do detailed fundamental research on all aspects of the company's business operations, sector and management and then make common sense judgments on the corporate quality. This is fair advice, but it's hardly very specific.

Buy Howard Schilit's Financial Shenanigans or Thornton O'glove's Quality of Earnings instead.

Mats Larsson, March 25, 2017

Others may quote and refer to the contents on this website provided that they have the author's consent and proper reference is made to investingbythebooks.com.