CREATIVE ACCOUNTING AND EARNING MANAGEMENT

Introduction
Financial statements are bound by laws and accounting standards. To break these is an offence and enforced as such. Judges enforce the letter of the law and where there are loopholes, the law may be changed. For judges the spirit of the law does not exist. However finance is too complicated to have a set of water-tight rules. Creative accounting and earnings management are euphemisms referring to accounting practices that may or may not follow the letter of the rules of standard accounting practices but certainly deviate from the spirit of those rules. They are characterized by excessive complication and the use of novel ways of characterizing income, assets, or liabilities. The terms "innovative" or "aggressive" are also sometimes used.

The term as generally understood refers to systematic misrepresentation of the true income and assets of corporations or other organizations. "Creative accounting" is at the root of a number of accounting scandals, and many proposals for accounting reform - usually centering on an updated analysis of capital and factors of production that would correctly reflect how value is added.

The idea of Creative Accounting, financial engineering, cosmetic accounting or profiteering is not a new concept to the Accounting world; in fact it is a widely used method to ensure that companies meet their estimates so as to prevent stock price crashes. In most cases it is referred as “cooking of books”. However, the technique is commonly used to conceal corporate fraud by adjusting the accounting information to suite the needs of the perpetrator.

Definition
Creative Accounting is a process in which a company firstly estimates their financial position, and then works backwards in order to achieve these desired figures.

Why creative accounting?
An annual review provides information on the financial position of a company. It is a snapshot of the company situation, as well as a history of change. However the message the review gives is often taken to be about the future position of the company. In particular investors and the capital market will base their decisions on results to date and the prognosis for the future. The shareholder and market reaction is related more and more to managers' actions and directors are increasingly judged on profit, growth and EPS and have large bonuses at stake. So companies (and directors) want to use the report to present the message they want investors to see, and at times this needs creative accounting.

Justified reasons for creative accounting
There may be one-off events which so distort the figures that the underlying health of the company is obscured. Accounting techniques may be used to produce more meaningful figures and avoid unjustified market pessimism. In such cases the changes may be clearly indicated in the notes to the accounts.
Unjustified creative accounting

However more often than not creative accounting is used to:

- Hide a particularly bad year for the company; force an exceptionally good year or continue the pressure to always be the best;
- Smooth out results to give an impression of stability or sustained improvement;
- Hide large profits by monopolies under anti-trust threat; boost assets to avoid take-over.
- Distortion in one year often increases the need to distort the next year. Typically the bad year continues and the company gets more tied into misleading figures, often seeming to devote more time to presentation of figures rather than management of the company. Examples of creative accounting What sort of things can be done as creative accounting? Acquisitions can hide poorer results or boost EPS. A large provision can be taken to cover reorganisation costs. These do not affect profitability but are taken against the assets of the company. Off-balance sheet financing. Items of the financial reports are omitted. This could be done via a partial subsidiary which the company controls. For example assets could be sold to this subsidiary. This produces a profit in the balance sheet, but nothing has changed. It is simple a shuffling of debt/credit between companies producing no overall increase in health or profitability.

Good-will and brand names. While brand names are a powerful marketing tool, companies that have included them in their assets have done so to increase the value of the assets when they would otherwise have seemed poor. A further problem is the valuation of a brand name which can be arbitrary and is not independently verifiable.

Capitalizing R&D. The company may capitalize its R&D expenditure. Instead of writing it off as cost, it was added to assets in "know how". The approach is similar to the way brand names can be handled. Depreciation. The British Airport Authority depreciate runways over 99 years. This means in effect they ignore depreciation of the runways. However they are at least open and consistent.

Moving operating costs to reduced assets. The company had to renew the pipes in a major chemical complex. This was simply to replace old equipment. The company did not record this as an operating cost, but classified it as "environmental activity" and wrote it off against assets.

Something clearly a cost, and affecting the year's results, has been moved from the cash stream of the company.

Creativity versus complicity Creative accounting affects the value of assets and liabilities, and also the allocation of changes to assets/liabilities or profit/loss.

Infamous cases are not creative accounting but fraud. However a typical feature of creative accountancy is that it is to a greater or lesser extent hidden and is often result of sustained poor performance. Engaging in creative accounting is then a possible first step towards pushing at the boundaries of the law. And the danger is that respectable
executives lose sight of where the boundaries are, and end up like directors committing fraud.

**Types of creative accounting techniques**
There are two major classes of creative accounting techniques which are

- On balance sheet
- Off balance sheet

The two can be further be categorized into the following types

- **Big bath charges**
  This application is applied when a company places large amounts of money into charges associated with company restructuring, this in turn, alleviates finances from the balance sheet giving them a so called big bath. The theory behind this on balance sheet technique is that when future earnings fall short, these conservative estimates miraculously become income and allow the company to achieve their expected earnings.

- **Creative Acquisition accounting**
  This occurs when companies allocate a large portion of an acquisition price as "in process"
  Research and Development can also be used advantageously due to the fact that this allocation can be written off in a one-time charge.

- **Cookie Jar Reserves**
  This application is achieved when companies portray unrealistic assumptions when calculating estimates for sales returns, loan losses or warranty costs. These accruals are then hidden in "cookie jars" during good times and used up during bad times.

- **Materiality**
  This occurs when a company intentionally records errors within a defined percentage ceiling and when they are questioned or challenged on the implied errors they simply argue that the profits are too small to matter.

- **Revenue Recognition**
  Is a method applied when companies increase their earnings by recognizing a sale prior to the completion of that sale, before the product is delivered to the customer or at a time when the customer still has the option to terminate the deal resulting is a lower revenue being observed.

**Other Techniques**

- **Round trip technique**
  The round trip technique used to trade stocks is a method used to increase the volume of transactions through buying and selling products simultaneously between companies working together. It is a manipulation practice which
misrepresents the number of transactions happening. This gives the company the ability to increase their revenues and expenses without changing the net income of the company.

Round tripping, also known as "capacity swaps", formally known as "capacity purchase agreements". Are very controversial business transactions. In some cases they are legitimate transactions but in other cases they may be used to simply improve the books. Example a company may be engaged in these "round tripping" transactions, companies would buy space on one another's networks (assuming a dot com company) at the same prices and then count the sales as revenue. No money is actually gained or paid by either firm, so the transactions improve the look of the company's books without actually contributing to the value of the company.

- Fake revenue and reserves depletion
  Each year fake revenue was recorded and accounts receivable were increased, then the entries were reversed in the fourth quarter to hide this from their auditors. They booked revenue that should have been taken later and used their financial reserves. The accounting methods were not in accordance with GAAP, such as inappropriate depreciation of assets and delayed recognition of insurance claims. This also includes
  - irregular charges against merger reserves
  - false coding of services sold to customers
  - delayed recognition of cancellation of membership and charge backs
  - recording of fictitious revenues

- Off Balance sheet financing
  Off-balance-sheet financing will always result in low financing costs and managing its earnings by offsetting losses with "one-time" gains resulting from the sale of large assets

- The one-time charges mainly work in two ways: with the sale of an asset or the write-off of a business or inventory. The sale of an asset is simply a sale that results in a one-time cash inflow. A write-off however can be helpful in several ways. First, it can be timed to work against a one-time gain such that it has no effect on earnings and the company can get the write-off off the books with no attention drawn to the issue. Also, if the write-off is later found to be too large, which may have been the intention all along; some of it can be reimbursed at a future date, directly adding to profits. Usually it is timed to occur when the company is trying to cleanse the books and may occur at a time when it works against a one-time gain, leaving the net effect whatever value is required to make the quarter.

- The creative accounting can also include the practice of finding well-timed one-time gains to offset weak performance and unexpected costs
• Use of corporate assets by executive can also be deemed part of ploy for creative accounting for example high peck allowances to executives which can be against or within the corporate policies.

• Reversals of Actual Expenses: In certain quarter, the company’s executives directed that its accounting staff reverse amounts that had been recorded for various expenses incurred and already paid. In each instance, these reversals were put back on the books in the subsequent quarter, thus moving the expenses to a period other than that in which they had actually been paid. The effect was to overstate company’s income during the period in which the expenses were actually incurred.

• "Gross Profit" Entries: the accounting staff may be directed by executives to make improper adjusting entries to reduce cost of goods sold and accounts payable in every quarter from the first quarter of first year through the first quarter of fourth year. There is no substantiality in these entries. They are specifically intended to manipulate Company’s reported earnings.

• Litigation Settlement: A company may recognized a big shilling amount from a litigation settlement, but when the settlement was not even complete. It is absolutely improper and is done in order to increase the reported income.

• "Dead Deal": Expenses the company could have written-off the pertinent expenses, according to Generally Accepted Accounting Principles. The company may not do the write-offs because this would reduce its income in the relevant periods. But, despite doing this, the company carried all these items as assets in the balance sheet.

• Inventory Shrink: When the physical inventory count was less than the inventory carried on company’s books, the company wrote down its book inventory to reflect this "shrink".

• Creative accounting practice can also take a form of capitalized the expense of acquiring new customers. This include marketing expenses, CD costs, and shipping costs. The technique may help to increase reported income earned.

• Improper accounting for expenses as long –term investments making the company look more profitable. The executives may take ordinary operating expenses, such as wages paid to workers for maintaining telecom systems, and treat them as capital expense accounts. This allows the firm to spread their expenses out over several years rather than accounting for them all at once. The results is inflated earnings because costs associated with long-term investments are spread out and subtracted from earnings over the life of the asset whereas operating expenses are deducted from earnings immediately. In doing this the company artificially lowered their expenses and may increase their profits. Therefore the value of the firm is also artificially inflated.
• Although not technically wrong, many annual and quarterly reports and presentations dive heavily into theoretical scenarios where "one-time charges" to earnings are excluded. What this means is for example, a lawsuit settlement amount would be taken out of the reported profit in one big chunk, even if it is paid out little by little over time (this practice is called reserving). Often, when explaining the quarterly results, a CEO might say "Well if we didn't take this charge for the lawsuit, we would have made this much money". Very often, the hypothetical situations proposed get even more complicated. The main "creative" aspect to this is when a "one time" "exceptional" charge really is something that is very common to the business.

• Banks are able to lend out most of the money they receive in deposit (they also can lend money they borrow from other banks). However, to protect against bad loans, banks must keep aside a supply of money called a "reserve". The bank, within general guidelines, gets to set the size of this reserve to what it feels is prudent compared to how risky its outstanding loans are. However, when the bank wants to make it look like it made more money this quarter than last, one way to do that is to take money from the reserve and call it profit with the excuse that the loans are safer now than before and that amount was no longer needed.

• One of the main genres of "creative accounting" is known as slush fund accounting, whereby some earnings from this quarter are hidden away just in case the profit from next quarter is not enough for the management to make their bonuses.

• Creative accounting is not limited to large firms with banks of accountants. Smaller companies often use creative accounting, but for tax saving purposes rather than meeting bonuses or shareholder expectations. Salaries are sometimes included in profits to benefit from corporation tax rates being lower than personal tax rates and spouses are sometimes put on the books as employees though they may never have worked for the company. As smaller companies are generally subject to less onerous rules - and many of them fall below the limit required for a full annual audit every year - much of the creative accounting in this sector does not get a lot of publicity.

**Earning Management**
"Earnings Management" occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or to influence contractual outcomes that depend on reported accounting numbers.

Earnings management usually involves the artificial increase (or decrease) of revenues, profits, or earnings per share figures through aggressive accounting tactics. Aggressive earnings management is a form of fraud and differs from reporting error.
Management wishing to show earnings at a certain level or following a certain pattern seek loopholes in financial reporting standards that allow them to adjust the numbers as far as is practicable to achieve their desired aim or to satisfy projections by financial analysts. These adjustments amount to fraudulent financial reporting when they fall 'outside the bounds of acceptable accounting practice'. Drivers for such behaviour include market expectations, personal realisation of a bonus, and maintenance of position within a market sector. In most cases conformance to acceptable accounting practices is a matter of personal integrity. Aggressive earnings management becomes more probable when a company is affected by a downturn in business.

It is relatively easy for an auditor to detect error but earnings management can involve sophisticated fraud that is covert. The requirement for management to assert that the accounts have been prepared properly offers no protection where those managers have already entered into conscious deceit and fraud. Auditors need to distinguish fraud from error by identifying the presence of intention.

The main forms of earnings management are as follows:
- unsuitable revenue recognition
- inappropriate accruals and estimates of liabilities
- excessive provisions and generous reserve accounting
- Intentional minor breaches of financial reporting requirements that aggregate to a material breach.

Creative Accounting is increasing and will remain with us. As a personal rule of thumb: where the accounting is open and documented it is there to handle special situations. Where it is hidden or disguised, it is a case of a company hiding its true position. And given that the annual and half-yearly reviews are the only financial statements the shareholders receive, hiding the true position of a company is simply misleading the owners of the company and should be regarded as fraud.

Corporate scandals and financial frauds have always permeated the world of commerce. Growing financial innovation coupled with newer and complicated accounting standards has resulted in the increased sophistication of financial statement fraud.
**Checklist for students to understand reason for creative accounting**

**Figure 1: Questions on profit manipulation**

You are required to explain the likely motivation a company's directors might have to manipulate its reported profit

(a) upwards; or

(b) downwards; or

(c) it is not possible to tell as it depends upon the particular circumstances, in the following situations.

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
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<tbody>
<tr>
<td>1 A company that faces a high (and difficult to meet) security analysts' (consensus) profit forecast.</td>
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<td>2 A listed company which prepares interim financial statements.</td>
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<td>3 A recently taken-over company.</td>
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<td>4 A company whose directors are considering changing the status of the company from private to publicly listed. That is they are planning an Initial Public Offering (IPO).</td>
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<td>5 A large regulated utility company.</td>
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<td>6 A company operating in an economy that is moving into recession.</td>
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<td>7 A company whose trade unions are about to submit a large wage demand.</td>
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<td>8 A company which is rumoured to be subjected to a hostile take-over bid in the next few weeks.</td>
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<td>9 A company that is performing below its industry average.</td>
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<td>10 A company whose directors are on a profit related bonus scheme.</td>
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<td>11 A company that is in fairly permanent decline.</td>
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<td>12 A company that has borrowed heavily and is highly geared.</td>
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<td>13 A company that operates in an industry known for highly volatile profits.</td>
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<td>14 A company that is faced with severe foreign competition.</td>
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Methods of detecting creative accounting

There are various methods of detecting creative accounting and here the reference will be made to the two of them

- Financial statements analysis using ratio and the less difficult
- Cash flow analysis

When the company reports its forecasted profit below expectation it triggers the need of its share price to drop proportionately. That’s why some investors go to great lengths to detect “red flags” warning of future earnings shortfalls. But that kind of analysis entails taking calculator in hand and digging into financial statements. Many investors don’t have the time it takes to perform a detailed financial statement analysis. Here’s the good news: there is an easier way by comparing cash flow to net income.

What you’re looking for are instances where net income increases, but cash flow doesn’t. You can find both figures on the cash flow statement. Here’s how to do it.

Concord wasn’t consistently profitable until its 1998 fiscal year (June 1998) when it reported earnings of $6 million. Earnings rose to $7.7 million in 1999 and then shot up to $19.6 million in fiscal 2000. But operating cash flow told a different story, falling 45 percent in fiscal 2000 from 1999. That was a red flag, since earnings more than doubled, but cash flow declined.

The signal worked! Earnings turned into losses the next year. Concord filed its June 2000 annual report on August 30, 2000. You would have had plenty of time to analyze the report before Concord’s share price peaked near $40 in mid-October. Earnings shortfalls drove it down to the $5 range a few months later.

The occurrence of rising earnings combined with falling cash flow doesn’t necessarily imply accounting shenanigans. Accounts receivables could increase because customers don’t have the cash to pay. An unforeseen sales slowdown could push inventory levels up. However, these events could also foretell an earnings slowdown.

Case study 1
Masemembe Msoja, whom people used to call him “MM” was an affluent business entrepreneur in the heart Dar Es Salaam city at the age of 35 his founded company, MM Technologies and after three years the company was listed with Dar Es Salaam Stock Exchange and the company’s shares were sold at a price of 5000/-. The company got into financial troubles beginning 2004 and Mr. Masemembe Msoja decided to play the trick as follows

- He first started off by creating fake customer purchase orders. He did this by making doctored bank records of fake customers payments for millions of Shillings.
- MM also forged real purchase orders from actual customers by using redacting tape to hide bogus terms on the orders
- MM also electronically altered bank statements to forge purchase orders

In the end, MM and the rest of the MM technologies accountants violate eight generally accepted accounting principals.
(a) The principle that interim financial reporting should be based upon the same accounting principles and practices used to prepare annual financial statements was violated

(b) The principle that financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions was violated

(c) The principle that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and effects of transactions, events and circumstances that change resources and claims to those resources was violated

(d) The principle that financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it was violated.

(e) The principle that financial reporting should provide information about an enterprise's financial performance during a period was violated. (f) The principle that financial reporting should be reliable in that it represents what it purports to represent was violated.

(g) The principle of completeness, which means that nothing is left out of the information that may be necessary to insure that it validly represents underlying events and conditions was violated and

(h) The principle that conservatism be used as a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered was violated.
Other issues in the case referred as Creative Accounting Tactics

1. Capitalizing Expenses. Violation of Matching Principle. Transfer of preproduction costs for shows to fixed assets such as construction of theaters.
2. Not reporting certain expenses and liabilities.
3. Transfer costs from one show currently running to another show that had not been opened.
4. Simply remove certain expenses and the related liabilities from the general ledger, literally erasing them from the company's books.
5. Acceleration of leasing revenue to recognize revenue immediately at the expense of future periods.
6. Schemed to inflate both the company’s earnings by hiding millions of shillings in expenses.

All of these manipulations are designed to understate expenses in order to fraudulently inflate earnings, portray unsuccessful theatrical productions as profitable, and to meet quarterly and annual projections provided to financial analysts.

CASES STUDY 2 Enron creative Accounting Schemes.

The corporation of Enron is a company that deals with electricity and natural gas that is based in Houston, Texas. Enron had 21,000 people working for them and was rated the seventh largest company in America. Enron was formed in 1985 and was then involved in the transmission and distribution of electricity and gas in the United States. Along with that, they were also involved in the development, construction and operation of power plants and pipelines that was a worldwide operation.

Everything seemed fine and profits were great. However, Enron conned the public into investing trillions of dollars into their stocks based on their earnings – which were not even real.

When Enron faced a major drop in stock prices, trillions of dollars of investors vanished. During 2001, each share went from $85 to $.30. As the books of Enron showed that they were doing very well, this was not the issue. Enron was transferring many of their liabilities to offshore accounting practices.

In 1999, Enron sold a 13% stake to LJM1 which was a fictional investment partnership. This was done so that Enron could have projected profits during the year before the pipeline had been scheduled to begin carrying fuel.

One of Enron’s crucial transactions involved just 5.7 million dollars. Enron had inflated its shareholders equity by one hundred and seventy-two million through bad accounting. The 5.7 million dollars was cash towards a deal. Since it was overlooked, Enron was able to add forty-five million dollars in profit in 1999 and remove seven hundred and eleven million dollars of its debts. Profits inflated by 351 million dollars.

As everything was put into the open, Enron had no choice but to file for bankruptcy protection as they were in a sixteen billion-dollar debt.
The Enron Company was then sold at an auction to Intell Management and Investment Company for 102 million dollars.

References