Creative Accounting, Fraud and International Accounting Standards

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Overview

• Based on Book: Creative Accounting, Fraud and International Accounting Scandals

• Investigates nature of creative accounting and fraud

• Examines history of accounting scandals

• Looks at creative accounting, fraud and accounting scandals in 13 countries worldwide

• Focus on political aspects
This is Brian; he used to be a professional magician.

He is our new financial accountant; he has all the skills...

Magicking figures out of thin air, vanishing unpleasant liabilities, producing assets where none existed before.
Two Quotes

“How do you explain to an intelligent public that it is possible for two companies in the same industry to follow entirely different accounting principles and both get a true and fair audit report?”

M. Lafferty

“Every company in the country is fiddling its profits”.

I. Griffiths
1. Fair Presentation

Using the flexibility within accounting to give a true and fair picture of the accounts so that they serve the interests of users
2. Creative Accounting

Using the flexibility within accounting to manage the measurement and presentation of the accounts so that they serve the interests of preparers.
3. Impression Management

Using the flexibility of the accounts (especially narrative and graphs) to convey a more favourable view than is warranted of a company’s results serving the interests of preparers.
4. Fraud

Stepping outside the Regulatory Framework deliberately to give a false picture of the accounts
Definitions

- **No Flexibility**
  - Regulatory framework eliminates accounting choice

- **Flexibility to give a “true and fair” view**
  - Working within regulatory framework to ensure users’ interests

- **Flexibility to give a creative view**
  - Working within regulatory framework to serve preparer’s interests

- **Flexibility to give a fraudulent view**
  - Working outside regulatory framework

**Within regulatory framework**

**Outside regulatory framework**
Managerial Motivation

1. **Personal incentives**
   e.g. Increase salaries through profit-related pay, bonus schemes, shares and share options, job security

2. **Market Expectations**
   e.g. Meet analysts’ expectations
   Profit smoothing

3. **Special Circumstances**
   e.g. Manage gearing
   New issues
   Mergers and acquisitions
   Decrease regulatory visibility
   New management team
Main Methods

A. Creative Accounting

1. Increase Income
e.g. premature sales recognition

2. Decrease Expenses
e.g. provision accounting
capitalisation of interest

3. Increase Assets
e.g. enhance goodwill
revalue fixed assets

4. Decrease Liabilities
e.g. off balance sheet financing
reclassifying debt as equity
Main Methods

B. Fraud

1. Misappropriate assets
   e.g. steal cash, inventory

2. Fictitious transactions
   e.g. invent sales or even whole subsidiaries

However, creative accounting and fraud overlap
# Accounting Scandals – Across Time

Table 7.1: A Selection of major scams and scandals across time

i. Ancient and medieval
   1. Cruciform monument, Mesopotamia second millennium BC
   2. Medieval merchants, Italy, fourteenth century
   3. Cely Family, England, late fifteenth century

ii. Seventeenth and eighteenth centuries
   4. Africa and India company of Scotland, Scotland, 1695
   5. South Sea Bubble, England, 1720

iii. Nineteenth Century
   6. Railway scandals 1840s-1860s, England
   7. City of Glasgow bank, Scotland, 1878

iv. Twentieth century: Before Second World War
   9. Royal Mail Steam Packet Company, UK, 1931
Accounting Scandals – Across Time

iv. Twentieth century: Before Second World War (cont.d)

v. Twentieth century: 1945-1980s
12. Reid Murray, Australia, 1963
15. Minisec, Australia, 1971
16. Equity Funding Corporation of America, US, 1973
17. Cambridge Credit, Australia, 1974
18. Renouf and Judge Corporations, New Zealand, 1980s
## Major Accounting Cases Covered

<table>
<thead>
<tr>
<th>AUSTRALIA</th>
<th>GERMANY</th>
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<tbody>
<tr>
<td>Adelaide Steamship</td>
<td>Co-op</td>
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<tr>
<td>Bond Corporation</td>
<td>Balsam</td>
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<td>Harris Scharfe</td>
<td>Bremer</td>
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<td>One.Tel</td>
<td>Comroad</td>
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<td>HIH Insurance</td>
<td>Flowtex</td>
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<td></td>
<td>Philip Holzmann</td>
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<td></td>
<td>Vulkan Verbund</td>
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<tr>
<td>CHINA</td>
<td>GREECE</td>
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<tr>
<td>Shenzhen Yuanye</td>
<td>Bank of Crete</td>
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<td>Great Wall Fund Raising</td>
<td>Dynamic Life</td>
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<td>Hongguang</td>
<td>Esta Finance</td>
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<td>Daqing Lianyi</td>
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<td>Kangsi Group</td>
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<td>Lantain Gufen</td>
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<tr>
<td>Zhengzhou Baiwen</td>
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<tr>
<td>Satyam</td>
<td>Fokker</td>
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<td>Royal Ahold</td>
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<td>RSV</td>
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<tr>
<th>ITALY</th>
<th>SPAIN</th>
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<tbody>
<tr>
<td>Parmalat</td>
<td>Afinsa and Forum Filatelico</td>
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<td></td>
<td>Banesto</td>
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<td>Caja Rural de Jaen</td>
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<td>Gescatera</td>
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<td>Promotura Social De Viviendas</td>
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<th>SWEDEN</th>
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<td>Fuji Sash</td>
<td>ABB</td>
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<td>Kanebo</td>
<td>Fermenta</td>
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<td>Livedoor</td>
<td>Prosolvia</td>
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<td>Morimoto-gumi</td>
<td>Skandia</td>
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<td>Nikko Cordial</td>
<td>Yaohan Japan</td>
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<td>Yamaichi Securities</td>
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<td>Mirror Group</td>
<td>Adelphia Communications</td>
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<td>Polly Peck</td>
<td>Bear Stearns</td>
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<td>Bank of Credit and Commerce International</td>
<td>Bre-X Minerals</td>
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<td>California Micro Devices</td>
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<td></td>
<td>Enron</td>
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<td>HealthSouth</td>
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<td>Lehman Brothers</td>
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<td>Madoff Securities International</td>
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<td>Tyco International</td>
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<td>WorldCom</td>
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<tr>
<td>Country</td>
<td>Authors</td>
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</tr>
<tr>
<td>Australia</td>
<td>Garry Carnegie and Brendan O’Connell</td>
</tr>
<tr>
<td>China</td>
<td>Catherine Chen, Yuanyuan Hu, Jason Xiao</td>
</tr>
<tr>
<td>Germany</td>
<td>Hansrudi Lenz</td>
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<tr>
<td>Greece</td>
<td>Maria Krambia-Kapardis, George Kontos, Nikolaos Milonas</td>
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<tr>
<td>India</td>
<td>Bhabatosh Banerjee</td>
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<tr>
<td>Italy</td>
<td>Andrea Melis</td>
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<tr>
<td>Japan</td>
<td>Kazuyuki Suda</td>
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<tr>
<td>Netherlands</td>
<td>Henk Langendijk</td>
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<tr>
<td>Spain</td>
<td>Nieves Carrera</td>
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<tr>
<td>Sweden</td>
<td>Gunnar Rimmel</td>
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<tr>
<td>UK</td>
<td>David Gwilliam, Richard Jackson</td>
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<tr>
<td>US</td>
<td>Charles Mulford and Eugene Comiskey</td>
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<tr>
<td>Bank Failures</td>
<td>Simon Norton</td>
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## Six Scandals in Depth

<table>
<thead>
<tr>
<th>Country</th>
<th>Company</th>
<th>Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>HIH</td>
<td>provisions, financial reinsurance, goodwill</td>
</tr>
<tr>
<td>China</td>
<td>Zhenzou/Baiwen</td>
<td>fraudulent sales, related party, capitalised and deferred expenses, bad debts, inflated assets</td>
</tr>
<tr>
<td>Greece</td>
<td>Bank of Crete</td>
<td>manipulation of accounting records, embezzlement</td>
</tr>
<tr>
<td>Italy</td>
<td>Parmalat</td>
<td>redeemable preference shares, debtors, false sales, debts as equity, related party, overstated assets</td>
</tr>
<tr>
<td>UK</td>
<td>AEI</td>
<td>Stocks, Contracts, Debts</td>
</tr>
<tr>
<td>US</td>
<td>Enron</td>
<td>Loans as sales, Off-balance sheet subsidiaries, Swapping sales</td>
</tr>
</tbody>
</table>
HIH

- Australian second largest insurance company
- Collapsed in 2001
- Three accounting issues:
  - i. Underprovided for future expected claims
  - ii. Reinsurance which did not transfer risk (e.g., side letters)
  - iii. Losses transferred to goodwill account

- Executives prosecuted
- Anderson’s criticised for lack of independence, failure of audit committee and consultancy work
- Corporate Law Economic Reform Program Act 2004
Zhenzhou Baiwen

- Company dealing with household appliances
- Fifth largest company in China in 1997
- 2002 ran into serious problems
- Accounting Issues:
  i. Fraudulent sales
  ii. Misused raised capital
  iii. Capitalised expenses
  iv. Deferred expenses
  v. Inflated assets
  vi. Related party provisions
Zhenzhou Baiwen

- Zhengzhou auditing company fined
- Failures of governance
  i. Board of directors
  ii. Supervisory board
  iii. Local government

- Consequences
  i. Revised corporate governance guidelines
  ii. Changes to Law
Bank of Crete

• Koskotas, a fraudster

• From ages 15-25 in US commits 64 forgery offences as well as forging academic qualifications

• 1979 starts work Bank of Crete

• 1980 Head of Internal Audit

• Steals US $ 1,555,000 and deposits them with Westminster Bank
Bank of Crete

- Overall embezzles US $32 million
- Forges letters and documents to cover tracks
- External audit failure
- Detected through a special audit
- Close connection with Andreas Papandreou, acquitted
- Corporate Governance code mandatory
- Bank of Crete privatised
Parmalat

• European Enron
• 2003 Parmalat defaults on $150 million bond
• Accounting Issues
  i. Fictitious sales
  ii. Double billing
  iii. Fabrication of operating subsidiaries’ sales
  iv. Not recording debts
  v. Recording debt as equity
  vi. Overstating assets
  vii. A forged €3.95 billion Bank of America cheque
Parmalat

- Governance Issues
  i. Tanzi family dominate Board
  ii. Non-independent non-executive directors
  iii. Audit committee lacks independence
  iv. Board of stability auditors ineffective

- External auditors failed in monitoring role
- Aftermath
  i. Changes to audit regulations
  ii. Changes in 8th Directive
AEI

- UK Company taken over by GEC
- Contested bid
- AEI forecasts a £10 million profit
- GEC published results £4.5 million loss
- Political controversy
- UK Accounting Standards Steering Committee formed
ENRON

- Highly Successful company
- Off-balance sheet financing, fictitious income, misreported cashflow
- Seventh biggest company in US, Bankruptcy
- Sarbanes Oxley Act
Some Themes

1. Overstrong personalities

- Charismatic persuaders and conmen
  
  e.g. In UK, Robert Maxwell and Asil Nadir  
       In US, Bernie Ebbers at WorldCom  
       In Spain, Mario Conde at Banesto
Some Themes

2. Managerial Motivations

- Cover up bad performance 30
- Personal benefits 35
- Meet listing requirements 5
Some Themes

3. Failure of Internal Control

Frequent Examples:

- At Zhenzou Baiwen failure of supervisory, board, independent directors and state controlled shareholders

- At Parmalat no independent directors, supervisory board and audit committee failed
Some Themes

4. Failure of External Auditors

Frequent features:

- In all seven Chinese cases negligent or complicit auditors
- At Parmalat auditors failed may have let company post a letter to Bank
- Comroad surprising failure of auditor to spot a non-existent subsidiary
- In Spain at Forum auditors did spot some irregularities, but failed to question sales and repurchase agreements
Aftermath

Short term, generally

- Loss of share price
- Company taken over or goes into liquidation
- Directors jailed or fined
- Auditors fined
Aftermath

Longer Term

Regulations especially:

i. changes in law

ii. new Codes of Corporate Governance

Continual revisions

Gradual increase in laws, regulations and political interference
Theoretical model to reduce creative accounting and fraud

Potential for creative accounting and fraud

Enhanced by

Motives
- Personal
- Market

Environmental opportunities
- Lax rules and regulations
- Poor supervision
- Inappropriate reward and incentive structures

Reduced by

Environmental constraints
- Appropriate reward and incentive structures
- Better regulations and code of governance
- Enhanced supervision

Enforcement and ethics
- Harsher penalties
- Code of ethics
How can this be Stopped?

Environmental Constraints

1. Appropriate reward and incentive structure

2. Better regulations and codes of Corporate Governance
   i. Enforcement and Ethics
   ii. Better enforcement
   iii. Code of ethics
   iv. Enhanced supervision
Conclusion

- Creative Accounting and Fraud perennial problems
- Over 12 countries, we study at least 58 different instances of accounting scams
- Sensational collapses e.g., HIH in Australia, Zhenzhou Baiwen in China, Parmalat in Italy and Enron in US
- Arise from managerial motivation for personal gain
- Often promulgated by charismatic persuaders
- Facilitated by poor corporate governance and failure of external audit
- Lead to financial loss and increased legislation
- Darwinian rule of the fittest