Bachelor Thesis

Creative accounting: A discussion on the tricks used by accountants to manipulate their financial statements.

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Table of contents

Abstract

Account manipulation occurs when managers of organizations show different accounting results than the real results, in order to attract potential investors. There are various reasons for this type of behavior to occur, and many ways to achieve the manipulation. Account manipulation can have a big impact on reported earnings, so it is an important issue. This paper will examine the different possible ways accountants use, in order to falsify their book records, and will provide solutions which, can help prevent this type of behavior to occur in the future.

Introduction of the thesis

Accounts manipulation, also known as creative accounting or earnings management have been used for a long time. Managers across different countries have been taking advantage of the accounting system to trick investors. Although accounting standards are in place, accountants find ways to manipulate their financial information. The manipulation can be done in several ways.

This paper's aim is to tackle the issue of account manipulation. This will be achieved by understanding the theory behind it, which will eventually lead to solutions that will prohibit managers to report financial information, which does not reflect the real performance of the organization.

This paper is divided into five chapters. The first chapter will define some terms. Accounting and creative accounting will be defined. Then the term fraud will be defined so as to make the difference between account manipulation and fraud. The second chapter, will discuss other concepts and conventions in accounting. Understanding these concepts will give a better knowledge on how accounting is treated. This chapter will also explain the accounting regulatory body as it is responsible for the well being of the accounting profession. The third chapter, will elaborate the different reasons behind the manipulative behavior. Understanding the reasons can help provide solutions to the problem. The chapter will also discuss briefly some ethical issues in accounting as it is a crucial element when preparing financial statements. The fourth chapter will discuss the possible ways, firms use in order to manipulate their books. The chapter will begin with a brief explanation of financial statements as the information provided to potential investors lies within these statements. Also, to understand how the theory works in practice, and how manipulation can turn into fraud, the Enron case will be studied. Enron is the example chosen because it is considered as the biggest fraud in history.

Finally, the last chapter will provide solutions which can improve the accounting system and eliminate the risks taken by investors, when dealing with fraudulent organizations. This paper should answer my research questions, which are **why do firms**

engage in a manipulative behavior? How can manipulation be achieved? And how can the current accounting system be improved?

Introduction of chapter 1

The first chapter will define the concepts of accounting and creative accounting. It will also define the term fraud, so as to make the difference between fraud and creative accounting.

What is accounting?

Accounting originally started as a stewardship function, as a result of a separation of ownership and control of resources. The shareholders owned the business but the managers controlled it. Shareholders were not able to verify all the business transactions and the performance of managers, they required the mangers to make regular reports on their activities by using accounting. This is what we call financial reporting. According to the agent/principal theory, due to asymmetric information, principal cannot know whether the agent is acting for the benefit of the firm or whether for his own benefit. Thus principals demand financial reporting, so as to track the agent's performance.

Business is now more complicated, due to globalization and the complication of financial markets. Investors are now able to buy stocks in various entities around the world. A need for financial reporting has increased largely over the years, in order to verify the business performance. However, hiding and manipulating information also grew, so investors are demanding a more regulated system.

Accounting is defined as the systematic recording, reporting and analysis of financial transactions of a business. Accounting allows a company to analyze the financial performance of the business, and look at statistics such as net profit.

Accounting systems are designed to provide information concerning the financial performance of the organization to users. There are two types of users, external and internal users. Internal users are within the entity, for example managers. They are provided with financial information so they can make decisions. External users are outside the organization. They consist of investors (or potential investors), government, creditors, tax authorities. External users need the financial information so they can make decisions whether to invest or not in a firm or also how much tax should be paid in case of tax authorities.

Information in financial accounting is made for decision makers who are outside the organization. We refer to them as external users. Without these financial information, they cannot know how the business is doing and if it is going concern or not. The information that lies in financial accounting is used for benchmarking. It helps comparing financial information between various entities across different countries. An important characteristic of financial accounting information is that it can be comparable between companies.
Financial accounting systems are characterized by a number of rules on how transactions should be reported.

Cost accounting on the other hand is designed for managers within the organization. Managers use this information for decision making within the organization, so there is no need for comparison between different companies. However, an important criteria is that the information should be relevant to decisions that managers make. The information provided to managers should help them make better decision, which will consequently improve the organization's performance.

The main reason of financial accounting is to provide investors (shareholders) or creditors (banks) with information concerning the organization and its performance. Financial information is prepared by using the rules provided by the GAAP in the US or the IFRS in Europe and other countries. The calculation of the cost of goods sold, inventory valuation and other financial information used for external users should be done according to the rules of the GAAP or the IFRS.

There exist various methods accountants use when preparing their financial statements, according to the book, cost management (Hilton):

(1) accruals method: is defined as an accounting system that recognizes revenuers when they are earned regardless of when the transaction takes place.

(2) absorption costing: a method that allows both direct and indirect costs to be inventoried.
(3) cash method: a method that reports revenues, costs and expenses in the accounting period in which cash is received, regardless of when the revenues are earned or expenses are incurred.
(4) direct costing: a method in which only direct costs are inventoried
(5) job-cost accounting: a method that requires to calculate costs on a line-item basis.

The accounting method a firm chooses to adopt, can have a major impact on revenues of the business and also on the expenses, thus by choosing a method firms can report a different result that another method. Therefore, depending on the firm's strategy, the firm can choose one method over another, in order to fulfill its goals.

What is creative accounting?

There exist no single definition for the term creative accounting. Some authors argue that, creative accounting is 'an assembly of techniques, options and freedom room left by accounting regulation, without moving away from laws or accounting requirements, allowing to the managers to change the financial result or the financial statements' (Gillet, quoted by Shabou and Boulika Taktak, 2002). Another definition of the term creative accounting is as follows, 'an assembly of procedures in order to change the profit, by increasing or decreasing, or to misrepresent the financial statements, or both of them' (Stolowy 200). A final definition of the term is, ' the transformation of financial accounting figures from what they actually are to what prepares desire by taking advantage of the existing rules and/or ignoring some or all of them' (Kamel Nasser 1993). The general idea behind this concept is that financial information is manipulated to represent a financial position and performance, that does not reflect its true position and performance.

Managers will not be able to manipulate their accounting figures if accounting rules will not allow them to do so. In the US, the financial information is prepared using the Generally Accepted Accounting Principles (GAAP), which is made by the Financial Accounting Standard Board (FASB). However, these rules are not sufficient as they still allow flexibility in accounting. There exist no standard formula for converting numbers into cash flows.

The objectives of account manipulation are to alter the two bases of wealth transfer: the earnings per share and the debt/equity ratio (Breton and Taffler 1995).

Earnings per share can be modified in two ways: first, by modifying the revenues or expenses, either by adding or removing them (modification of net income). The second way is by reporting a item before or after the profit used to get the earnings per share (classificatory manipulations).

On the other hand, debt to equity can be modified by falsely increasing the profits or by hiding certain debts through off-balance sheet financing devices.

The different methods of creative accounting are considered to be in four categories:

(1) Accounting rules allow companies to choose among the different accounting methods. A company is free to choose the method which will give the better image.

(2) In the accounting profession there exist a high degree of estimation, judgment and prediction. For example, in order to calculate a depreciation of an asset, companies will choose the method which will benefit them the most.

(3) Using artificial transactions can manipulate the amounts reported in the balance sheet and also move profits between accounting periods. This method can be achieved by adding two or more transactions and with a third party being involved.

(4) Transactions can be timed according to the firm so as to show the impression is desires in the accounts.

Later is this paper, the different methods used by firms to manipulate accounts will be discussed in detail.

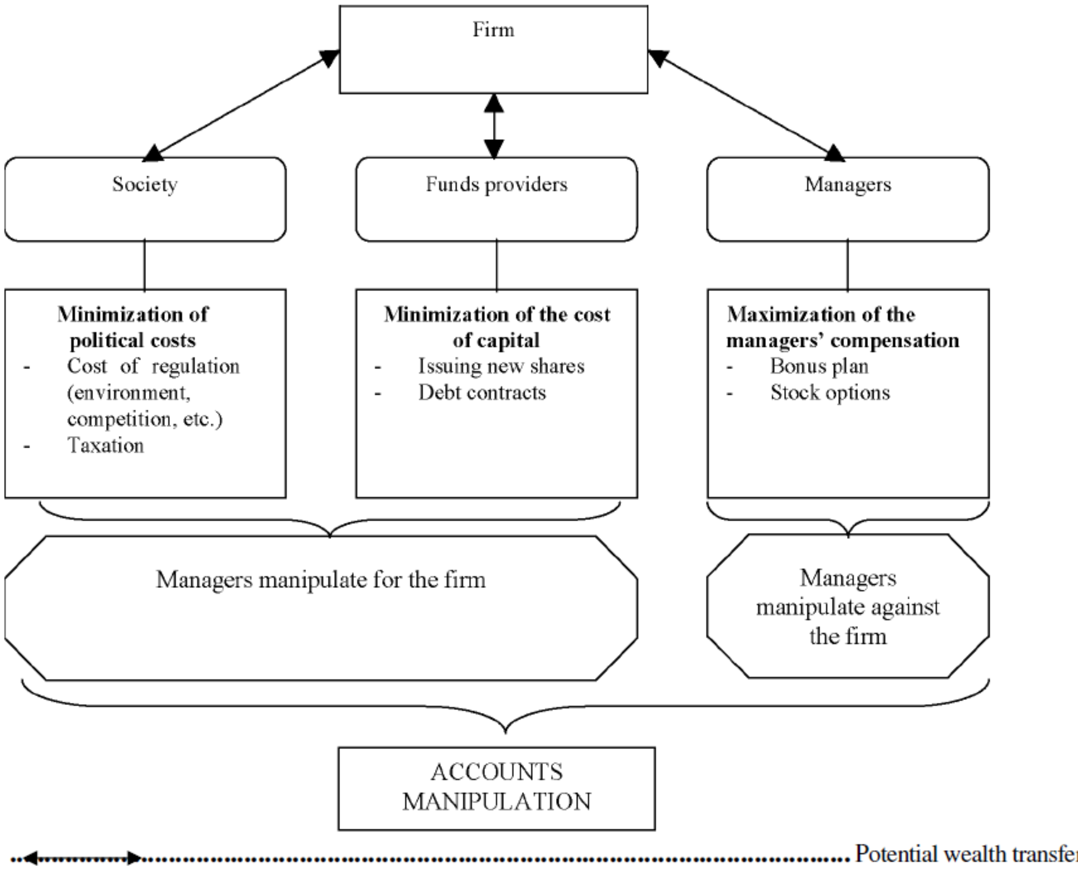


Figure 1 - Principles of Accounts Manipulation

According to this figure, there are two types of manipulation, one that managers use in order to manipulate for the firm. This type of manipulation occurs to trick external users. The second type of manipulation is when managers manipulate against the firm. This type of manipulation occurs within the entity so that the manager tricks the shareholders in order to get a higher compensation.

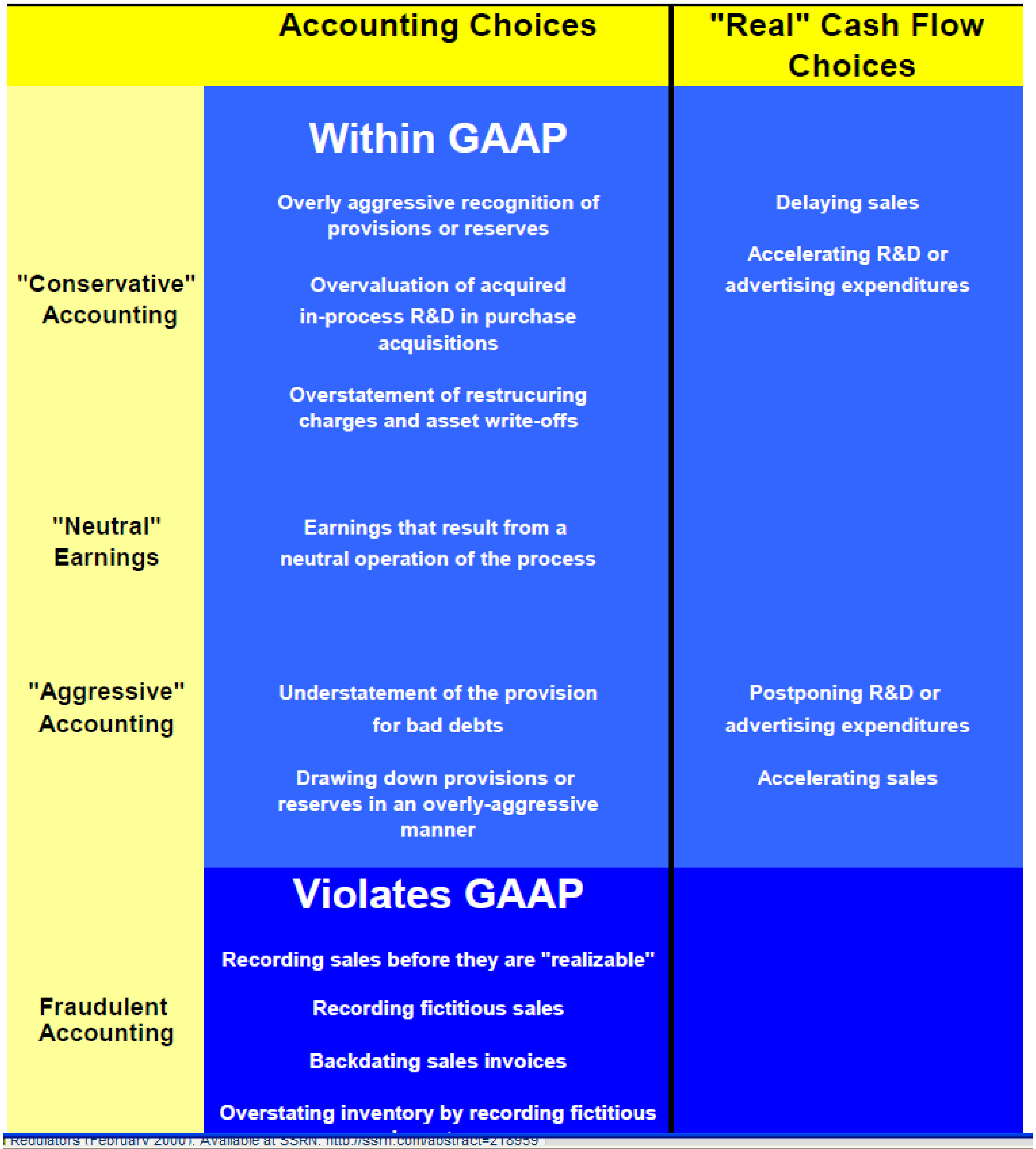
Creative accounting vs Fraud

Manipulation that does not lie within the law and standards is considered to be a fraud, according to Diana and Madalina. Engaging in the practices of creative accounting or manipulation accounting is within the law and thus is not considered to be a fraud. Fraud occurs when a firm commits an illegal act, for example if the firm decides to falsify invoices so it can increase its sales figures. On the other hand making a false estimation on bad debts is not considered to be a fraud.

According to Belkaoui (1989), real fraud is defined as 'falsifying or altering documents, deleting transactions from records, recording forged transactions or concealing significant information'. Due to the difficulty of the distinction between the two, the commission responsible for fraudulent financial reporting defined fraud as 'materially misleading financial statements' (NCFRR 1987).

To conclude, creative accounting deals with the misrepresentation of accounting figures, by following the standards set by the accounting conventions, while fraud is falsification of accounting figures made, by disobeying the law.

Figure 2: Distinction between fraud and earnings management



According to this figure, it is clear that fraud occurs when it violates GAAP. Other forms of manipulation are within the accounting standards and thus are legitimate.

Conclusion of the first chapter

As we have seen previously, accounting is needed in order to report the transactions made by a firm. Accounting is required in order to eliminate the asymmetric information.

Creative accounting, is the use of techniques, to falsify the book records. Creative accounting is practiced in order for a firm to look better in the market, which will lead to investors willing to invest in that firm.

However, creative accounting is not recognized as being fraud, as long as the firm operates within the standards of the GAAP in the US, or the IFRS internationally. Thus firms will continue to falsify their books as they do not get punished. This paper's aim is to find solutions, so it can improve the accounting system, which will prevent this type of behavior. A more regulated accounting system, will guarantee the safety of the primary investors.

Introduction of chapter 2

The second chapter, will explain who is in charge for the well-functioning of the accounting profession. The chapter will begin, by explaining the accounting bodies that have the power to regulate the system. This chapter will also explain the conventions and concepts used by accountants, when preparing their financial statements.

The accounting regulatory body

Accounting regulations play an important role in the society, as they are responsible for the balance of economic power between different parties. The main goal of the regulatory body is to make sure, that the accounting profession does not lose its credibility. The regulatory body, has the power to modify the laws in accounting, by regulating the accounting system. The accounting regulations comes in the form of accounting standards. The regulatory body is responsible for the fact that accounting information that flows in the market is relevant, which means the information provided, should help users make better decisions. The information provided in any organization, is usually aimed for the primary users, which consist of high-risking investors. So regulations should help those investors, who are the providers of risk capital to business. It should guarantee that, the information that they receive, will actually benefit them, by making better decisions and not only for the benefit of the firm, so it can have a larger capital.

In most countries, accounting is regulated by two means. Either by local laws, or by a system of accounting regulations, in the form of standards. However, recently, countries started to follow the standards made by the International Accounting Standards Committee (IASC). The IASC was formed in 1973 via an agreement between several leading national professional accounting bodies. In 1995, the International Organization of Securities Commissions (IOSC) decided that the IASC would be responsible for developing a set of core standards. In 2001, the standard setting body was renamed as the International Accounting Standards Board (IASB), which is in charge of issuing International Financial Reporting Standards (IFRS). After its establishment, many countries started to adopt the international standards, made by the IFRS, for example in Europe, starting in 2005, companies in the member states are obliged to follow the rules set by the IFRS. Other countries like Australia and New Zealand also started to follow the IFRS. The idea is to get as many countries possible to follow the rules of the IFRS, so that the local laws disappear, and an international law is followed by all the countries. This will decrease the risk of manipulation and also help benchmark firms across countries. However, the Financial Accounting Standards Board, a national standard setter in the USA, is likely to exist in the future. A convergence of the two systems is being discussed.

The infrastructure of the financial reporting. Schipper (2000) identified four elements as forming part of the infrastructure of financial reporting.

1) The effectiveness of mechanisms for identifying and resolving interpretative questions.
2) The structure, processes, independence, expertise, incentives and resource base of the standards setting organization.
3) Auditing and auditors
4) Enforcement of accounting standards and the supporting regulations.

In many countries, national systems have one of the four elements weak. Fearnley and Macve (2001) identify some of the weaknesses that exist in some national systems: weak support mechanisms for auditors, lack of effective sanctions against directors and differences between the legal framework and practice. The IFRS's goal is to find a system, where the weaknesses are minimized, so as to protect investors form fraudulent organizations, that may produce misleading information, which due to asymmetric information, investors cannot know if the information given is fraudulent or not.

Regulation of accounting can have many social and economic effects. As such the accounting standard-setting process is considered to be a very political process, with various interested parties lobbying the standard setters. According to the capture theory, although accounting regulation is introduced to protect the public, the regulatory mechanism are often controlled so as to protect the interests of self-interested groups within the society, typically does activities are most affected by the regulation. Thus, if accounting should be regulated, it should be according to the public interest theory, which proposes that regulation should be introduced to protect the public. According to Scott (2003), following the public theory, the regulatory does is best to regulate so as to maximize social welfare. This kind of regulation will benefit the public and the investors included.

Accounting conventions and concepts

When preparing financial statements, whether it is for external or internal users, a clear objective has to be that the accounts fairly represent the true value of the business. The theory of accounting have developed the concept of true and fair view, with an aim to ensure and assess whether the accounts do reflect the business activities.
In order to support this concept, accounting has adopted some concepts that help assuring that accounting information is accrual and consistent.

The most common convention is the historical cost convention, which states that transactions should be recorded at the price when the asset is originally bought. Historical cost accounting does not take into consideration inflation, so in case of inflation, assets will be overvalued.

The other conventions can be summarized as follows:

Monetary measurement: under this concept, accountants do not report items in their statements unless they can be quantified in monetary terms. Examples of theses kind of items include workforce skill, morale, brand recognition, management quality.

Separate entity: this convention states that the business and the owner are separated. It is mandatory to record the business transactions separately, to distinguish them form the owner's transactions.

Realization: under this convention, a transaction is recognized at the point of sale or transfer of legal ownership. For example when a company sales a product to another company, the transaction is recognized at the point of contract and not necessarily when the seller receives the cash. The seller can grant a credit to the customer, which the latter will pay it back in several weeks later.

Materiality: under the IASB framework, an item is considered to be material if, its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Accounting concepts

There exist four accounting concepts used when preparing any sets of accounts:

Going Concern: Under this concept, the business is not going out of business in the near further. This has important implications when valuing assets and liabilities.

Consistency: Transactions and valuation methods are kept the same form year to year. This will help make easier comparisons of financial performance form year to year. If accounting methods or policies are changed, companies are required to report this change and explain the impact of this change.

Prudence: Profits are not recognized in the books until the sale has been completed.

Matching: Under this concept, income should be matched with the expense of the given accounting period.

Some key characteristics of accounting information:

Understandability: Accounting information should be presented in a way that is understandable to users, assuming that the users have a reasonable knowledge of accounting.

Relevance: Accounting information is considered to be relevant if it is useful as its aim is to assist a user to form or confirm a view. It should be relevant so it can helpful for users to make better decisions.

Consistency: Accounting information should have a consistent treatment of similar items and application of accounting policies.

Comparability: under the IASB framework, financial statements should be comparable to financial statements of different entities, methods of measurement must be consistent but should be changed if no longer relevant to an entity's circumstances.

Reliability: under the IASB, an item is considered to be reliable if it is free form bias and error and can be dependent upon by users to represent faithfully the underlying items it claims to represent.

Objectivity: an item should be reported in a neutral way, the item should be free from bias.

Conclusion of chapter 2

This chapter showed the bodies that are responsible for the accounting profession. They are the ones who should regulate the accounting system, so as to protect investors. The ideal is that the FASB and the IASB to merge into one global body so that, they can provide a global framework that guides firms all around the world to follow appropriately the rules given by the global body. In that way, all the firms have the same rules and everybody will be familiar with the rules. This will help decrease the chance of manipulation.

This chapter also explained what already exists in accounting. Financial statements are prepared according to those accounting concepts. The main goal of the accounting standards, is to assure that the information provided by the preparers has the key characteristics discussed previously. However, due to the fact that the standards are incomplete, it enables preparers to misrepresent information, which will consequently put in doubt the key characteristics. Thus, in order to guarantee that the financial information has the key characteristics discussed above, regulators should modify the concepts so as to make it clear, on how to report the items in the financial statements.

Introduction of chapter 3

The third chapter's aim is to understand why firms engage in a manipulative behavior. The different reasons that motivates firm to falsify their books will be explained. Also in this chapter, ethics in accounting will be discussed as it is a crucial element when preparing financial statements. This chapter should answer one of the research question, **why do firms engage in a manipulative behavior?**

Reasons behind the manipulative behavior

Manipulating financial information is not only a costly task but also a risky one. Karpoff, Lee and Martin (2008a) show that on average companies lose 38% of their market value when financial misrepresentations are publicly disclosed. Thus firms need to be very careful when engaging in manipulative behavior. Mangers will manipulate as long as the gain attributed with this manipulation is higher than the costs. The gains are in many forms such as bringing in new investors into the firm.

Creative accounting is practiced in order to align the interests among different groups. Different groups in the society seek to maximize their own utility. Managers aim is to pay the less taxes possible and to report high profits so he can get a higher bonus (specially when the firm has a bonus-scheme plan), shareholders expect high dividends, the employees to get a better salary and a higher profit share and finally the government to collect higher taxes. Creative accounting will benefit one party at the expense of the other.

The main reason of the practice of creative accounting is to change the reported earnings. Either by increasing or decreasing it, depending on the company's situation.

Some academics argue that managers use earnings management, in order to influence the firm short-term stock price. A main reason why managers are involved in account manipulation is to persuade investments in a firm in the form of selling stocks. In their studies, Teoh, Wong & Rao concluded that firms which are looking for new investors are more likely to have income-increasing depreciation policies and bad debt allowances, thus to report a higher amount of income, consequently to show that the firm is profitable which will then attract investors to invest in the firm by buying stocks.

Furthermore, Degeorge, Patel & Zeckhauser found that it is crucial for firms not to make losses and to achieve consistent earning growth. Achieving a consisting earning growth is achieved by smoothing the reported earnings. Income smoothing occurs because companies would rather report a steady growth in profits overtime than losses in bad periods. It can be done by making unnecessarily high provisions of liabilities and against asset values in good years so that the provisions be reduced and consequently in bad periods, the reported profits will be improved. The main reason for this kind of practice is due to the fact that, investors prefer to pay a premium for stocks with steady and predictable earnings streams, compared to earnings that are subject to fluctuations. Furthermore, income smoothing is within the US GAAP so is not considered to be a fraud.

Another bias that sometimes happens is the so-called the big bath accounting. It occurs when companies make loss in a period, seeks to maximize the reported loss in that period so that future period will look better.

On the other hand, other studies show the opposite, arguing that there is motive to underestimate earnings prior to management buyout. In their study, Perry and Williams support this hypothesis, which shows that there is income decreasing, the unexpected accruals are negative prior to a management buyout. This hypothesis states that there is incentive for managers to report earnings that are decreasing so that the buyout is the cheapest as possible, which will allow managers to offer the stock at a price which lies above the market price but still below what the firm is actually worth.

The main reasons of creative accounting fall in one of these areas:

(1) to obtain additional financing from banks
(2) to report unrealistic profits
(3) to inflate share prices
(4) to hide losses

(5) to attract customers by showing a more successful image

(6) to achieve a performance-related bonus

(7) to cover up theft

This manipulative behavior occurs through different situations, depending on what the company is looking for at the time, but the main reason is to falsify the records so it can be attractive to the public, which will consequently encourage investors to buy stocks and increase the firm's value.

Ethical issues behind accounting manipulation

When engaging in accounting, ethics are also involved. Ethics in accounting refers to the morals and judgments that a professional needs to follow when engaging in accounting. Financial users not only rely on his skill and ability but also on the individual's judgment. Accounting professionals created an accounting code that all the accounting professionals need to follow. The conduct or ethics oblige accounting professionals to have a high degree of self-discipline. Accountants are responsible for sticking to the code of ethics, so as the profession of accounting does not lose its confidence and credibility. The role of ethics in accounting is to guarantee that accountants will follow certain rules so they can conduct their profession in a fair way. It straightens the confidence of the public towards private firms.

There exist a set of guidelines made by the AICPA that can be used in the field of public accounts. The IIA (Institute of Internal Auditors) and the IMA (Institute of Management Accounts) created their own code of ethics which can also be used in the field of accounting. Since it is difficult to verify whether accountants are following the code of ethics it is the responsibility of all professional accounting organizations, to make sure that all their members follow the standard set of ethical guidelines.

Organizations cannot teach ethics to the accounting profession. Rather, it is the family, society, schools and colleges and professional organizations that are responsible in making sure ethics are embedded in a person. So the codes of ethics prepared by different institutions cannot teach a person to be ethical, rather it can help a person build a sense of ethics in a professional.

Nowadays ethics is needed in the profession of accounting, specially when the world is witnessing a turbulent economic time.

Conclusion of chapter 3

This chapter began by showing the different reasons behind the manipulative behavior. There are many reasons, but the main goal is to attract more investors.

Furthermore, as long as firms are manipulating their books, ethics are not taken into consideration. If all firms were acting in an ethical way, we would not have this problem. However, since people are driven by self-interest, they are willing to maximize their own wealth at the expense of others. So in order to prevent this manipulative behavior, firms should obey to the codes of ethics, which will then prevent them form acting in a dishonest way. Any firm that fails to obey to the codes of ethics should be punished by either imposing heavy fines or by forbidding the firm to continue its business operations. Only by imposing strict rules, firms will no longer falsify their books.

Introduction of chapter 4

The fourth chapter, will answer the question one of the research question, **how firms manipulate their accounting books?** This will be done, by showing the different possible ways to falsify the records in a legitimate way. This chapter will start by explaining the different financial statements used in accounting. It is important to recognize the different financial statements, as the information that is subject to manipulation, lies in those financial statements.
Also, in order to understand the theory of manipulation, the Enron fraud case will be examined.

Financial statements

The objective of financial statements is defined as follows in the Framework for the Preparation and Presentation of Financial Statements published by the IASC in 1989: " The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economics decisions" (paragraph 12).

The information regarding the financial position is given in the balance sheet. The balance sheet shows if the entity is going concern or not. Accountants will make sure that the organization is in good position, so it can be attractive to investors. Investors are interested in those firms that report high earnings, in order to receive a high return. Under the double entry system, we have the assets on one side and the liabilities and shareholder's equity on the other side. The two side should match each other. Managers' aim is to evaluate the assets and make sure the value of the assets will increase overtime. Investors who are seeking to invest in an organization will look at the two sides of the balance sheet. They will see if the firm has a high leverage or not.

In order to make the balance sheet, a financial statement known as the income statement needs to be done first. The income statement shows the performance of the organization as its aim is to show if the firm is making a profit or a loss. Obviously, manager's aim is to report a high profit in order to satisfy the shareholders. Parts of this profit will go as dividends for the shareholders and the other part will go as retained earnings in the balance sheet. Thus, accountants have to make sure the reporting of a high amount of profit in order to make the business look better in the market and thus to the investors. However, reporting high profits mean that the firm will pay high taxes. Accountants will spread the profits over the years so the firm pays the minimum amount of taxes possible.

Another important financial statement is the statement of owner's equity, also known as the statement of retained earnings or equity statement. The aim of this financial statement is to explain the changes in the retained earnings.

The problem is to figure out if the information provided to users regarding the financial position and the performance is the true representation of the firm. Creative accounting help preparers misrepresent information to benefit the organization. The task of accounting regulatory body is to make sure that the financial information provided to the users is not aimed to trick them, but to help them make better decisions.

How are the financial statements manipulated?

The most relevant information lies in the two financial statements discussed previously, the balance sheet and the income statement. When deciding whether to invest in a firm, investors usually look at the earning per share, EPS and the debt/equity ratio.

The earnings per share is defined as the proportion of a company's profit allocated to each outstanding share of common stock. Earning per share serves as company's profitability. Therefore, managers will make sure having the highest EPS possible.

On the other hand, debt to equity ratio is defined as a measure of a company's financial leverage calculated by dividing its total liabilities by stockholders equity. It indicates what proportion of equity and debt the company is using to finance its assets. Accountants will make sure to have the lowest debt to equity ratio possible.

In order to have a high EPS, managers should either increase the earnings or the decrease the numbers of shares. Decreasing the number of shares is a hard task as usually when a firm needs extra investments, it will deliver new shares for the new creditors. Thus the easiest way to increase the EPS, is to increase the earnings. Earnings per share can be modified in two ways: first, by adding or removing certain revenues or expenses, and second by presenting an item before or after the profit used to calculate the earnings per share.

On the other hand, in order to decrease the debt to equity ratio, managers should find ways to decrease the company's debt. Modification of the debt/equity ratio can be done by artificially inflating the profit or by hiding certain financing through off-balance sheet financing devices.

This section will discuss the possible ways managers can legally use to inflate the earnings and the cash flows they report.

David Schiff (1993: 94-95) identified six areas dues by firms in order to increase their earnings:

(1)- by hiding the pension liabilities
(2)- by capitalizing the expenses instead of writing them off
(3)- by reporting a faster increase of the receivables versus sales
(4)- by reaching negative cash flows
(5)- by consolidating the affiliates income and net worth
(6)- by following seemingly conservative practice in a situation of reverse direction.

Following the six areas means engaging in creative accounting. Reporting higher earnings will trick an potential investors as the information presented does not reflect the true value of the company, but rather a false estimation of the firm.

There exist also other ways to report higher earnings.

The first way is done by manipulating the estimates sales. Companies can falsify their estimates sales in order to report sales and earnings higher than they really are. Furthermore, for unsure periods, companies can pros pond their revenues and report them in bad periods. Reporting revenue can be difficult, as not all the auditors will argue the same when an item should be recorded as a revenue. Thus changing the estimates sales in a positive manner can trick investors.

The second way is accomplished by manipulating the prediction of bad debts. The way companies report their bad debts can have a large effect on earnings. Estimating bad debts simply means guessing how much money owned will not be paid back. The lower the amount estimated of debts, the higher the earnings will be. Thus companies will make sure to report the lowest amount possible of bad debts. There exist different methods on how to estimate bad debts. The first one is the allowance method. Under this method, bad debts is calculated as a percentage of the accounts receivable balance. Another method is the aging method. This method is based on the assumption that the longer an account balance is overdue, the less likely the debt will be paid, thus many companies keep an account receivable aging schedule, in which it summarizes each customer's credit purchases by the length of time. The last method is the percentage of credit sales method, where the bad debts are estimated as a percentage of credit sales. Firms that use the percentage of credit sales method, ignore any exiting balance in the allowance for bad debts account. Whenever the estimate fail to match actual bad debts, the percentage rate used to estimate bad debts is adjusts on future estimates.

Another way to report higher earnings is achieved by, adjusting the inventory. Companies are able to report a higher amount of earnings by changing the costs they estimate for inventory that will be replaced before it can be sold. For example Vitesse Semiconductor Corp, in 2002 reported inventory expenses of $30,5 million and $46,5 million in 2001. In the year 2003, it took no inventory expense but it wrote-off $7,4 million against a past established reserve for obsolete inventory. If it did not (erased) its reserve, $7,4 million would have come out of current earnings.

Manipulation can be achieved either by hiding some items, either by making false predictions. Since estimations is done in a subjective manner, it is hard for investors to verify if the firm will meet the estimations it has predicted. So regulators will find it hard to intervene on this issue. It is hard to punish firms based on their expectations as the market is unpredictable. However, regulators can modify the accounting system, in a way that will eliminate the chances that firms will hide items form their books. In case the regulatory body does not react on this issue, local governments can make laws that prohibit such a behavior. Firms that wishes to hide items from their books, just so it can look more attractive, should be fined by the government.

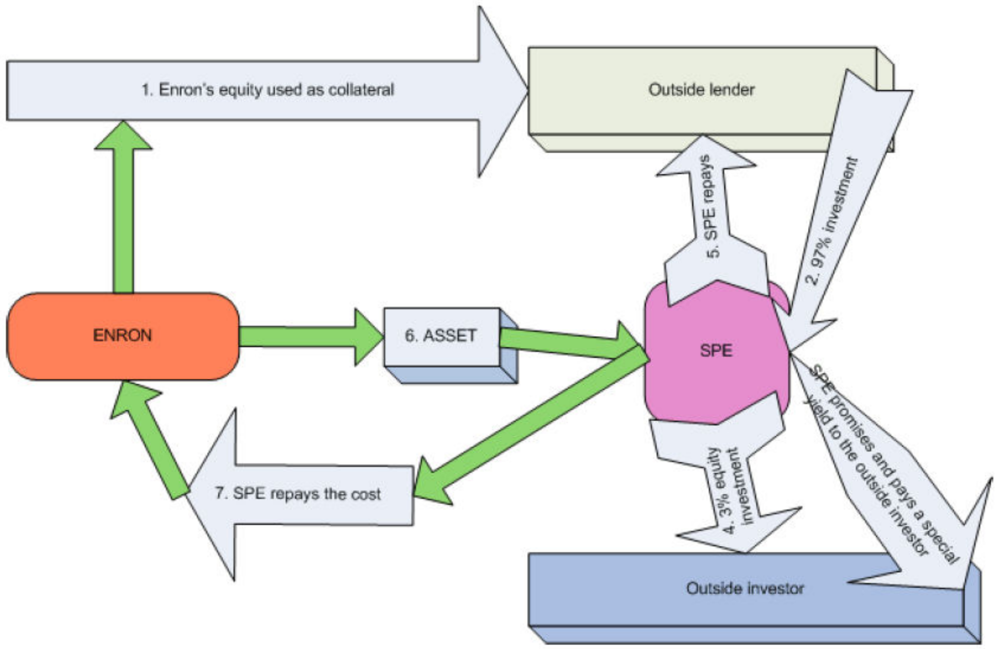
Enron fraud case

To get a better understanding of the difference between the so-called manipulation of accounting and fraud, the Enron case will be analyzed. This case will help understand how the theory works in practice.

Enron Corporation is known as the biggest fraud scandal in history. In the 90's, before the scandal occurred, Enron was considered as one of the top ten companies according to Forbes 500. Enron grew by expanding its market; it brought other energy companies in different continents. For making a pipeline and a factory it required a large amount of capital, so it needed to take a large amount of debt. However, prior to 2001 Enron had already lots of debts in its statements so in order to continue business, Enron had to keep the credit raking at investment rate, which made it difficult for Enron to take more debts. On top of that, Enron's profits were not equivalent to the investors' expectations, thus Enron's solution was to create partnerships and other special arrangements (Special Purpose Entity, or SPE), so it can take more debts. These small subsidies were created so that Enron has a good credit raking so that it looks profitable to investors. The SPE helped keep Enron' debts and losses away form its balance sheets.

Enron's goal was to overcome the rules of consolidation so it can take more debts without reporting it in its books, so it can look credible in the market. Non-consolidation is not illegal as long as it meets the criteria according to GAAP. First, it must be legally isolated from the transfer (i.e, sold to the SPE), second an independent party owner has to make a substantive amount of capital investment which would amount to at least 3% of the SPE' total capitalization. The independent third party owner must have control over the SPE in order to avoid consolidation.

Here is how SPEs functioned:



Adapted from Chary, VRK, "Ethics in Accounting. Global Cases and Experiences", 2004, Punjagutta, The ICFAI University Press, India, pg. 115

By using this strategy, Enron's recorded assets and profits were inflated or even non-existent. Debts and losses were put in the SPEs it has created and so they were not included in Enron's financial statements. The strategy used was not conform to the laws so it was considered as a fraud. As a result, on December 2, 2001 Enron was declared bankrupt. Due to this big event, the US Congress passed a law entitled the Sarbanes-Oxley Act, which placed stricter rules on auditors and made corporate executives criminally liable for lying about their accounts. However, although this law is in place in the US, firms still find ways to commit fraud which makes the accounting system still incomplete.

Conclusion of chapter 4

This chapter showed the different ways possible for firms to falsify their earnings. This manipulation will have an effect on the financial statements provided to different investors. Falsifying the earnings will make the financial statements more attractive, and thus will encourage investors to invest in the firm. Investors can be tricked as they will be provided with information that does not reflect the true value of the firm. Furthermore, firms will continue manipulating as it is still possible. The IFRS or the GAAP still allow firms to choose accounting methods they wish to use, they also allow firms to use either conservative accounting or aggressive accounting. These two types of accounting enable firms to engage in a manipulative behavior. So the main conclusion of this chapter is that there are many possible ways to falsify accounting records legally.

Enron tried to do the same by creating the SPE's. Although it Enron had lots of debts, it still managed to find ways to take more debts without affecting its credit raking. However, Enron did not follow the laws thus it was considered as a fraud.

Finally, It is the regulator's task now to find ways, which will make it difficult for firms to manipulate their books. The regulators should provide a more complete framework, which disallows any type of misrepresentation.

Introduction of chapter 5

Finally, the last chapter is about the solutions to the problem of manipulation. Having a good understanding of accounting and the concepts will help provide viable solutions. This final chapter should answer the research question, **how can the current accounting system be improved?**

Solutions

Since the accounting system is incomplete, there is a lot that can be done in order to improve it. In case the FASB and the IASB do not merge, they can both regulate the system as so to make it easier for investors to understand how and why companies' earnings numbers have been reported. They should find ways, on how to get the presentation of financial statements more consistent, which will consequently enable investors to figure out the accounting tricks used to mislead those investors.

Furthermore, regulators need to make sure that firms are not able anymore to present information to investors, that do not show the real image of the firm. Protecting primary investors form fraudulent organization, should be the regulator's main goal. They also have to define more clearly elements of financial information, for example what constitutes an operating, investing or financing item.

The concepts of accounting should reduce the risk of manipulation, however these concepts are not complete as the rules of accounting still allow much freedom for preparers of financial statements, there exist a high degree of flexibility in accounting. These concepts are taken into consideration when preparing the financial statements. It gives accountants freedom to choose among different methods for the valuation of their assets, so there will always be a judgment, as preparers will use the method which will benefit the organization the most. Therefore accountants are being subjective when preparing their financial statements, which is the opposite of being objective, one of the key characteristics of accounting information.

Furthermore, in accounting, the efficiency perspective asserts that different organizational characteristics, explain why different companies use different accounting method. Advocates of this perspective, argue that firms should be allowed to choose accounting methods, that best reflect their performance. It could be that firms will be more efficient, if they get to choose which accounting method suits their business the best, but it will be more difficult for comparisons and verification when there exist multiple set of methods. Therefore the first task is to guarantee a single accounting method, which will consequently reduce the risks of manipulation and also increase the comparability benefits when the regulations take place.

In the definition of the term relevance, it says that it can be helpful for users to make better decisions. However, when firms choose the accounting method they want to follow, the result can be completely different when using another method. So companies can easily mislead investors for many reasons depending on the company's circumstances. Thus by manipulating information, it does not help users make better decisions but rather make decisions that will best serve the firm. Thus another solution, is to modify the international framework done by the IFRS, that guides firms when preparing their financial statements. This framework should clearly guide accountants when preparing their statements. In this framework there should also be penalties. Firms that do not obey the steps and rules of this framework should be punished. Imposing heavy fines can reduce the chances that firms will operate in an unethical manner. Following a more complete framework, will guarantee the safety of the primary investors from fraudulent organizations.

Finally, having more consistent information in the financial statements, investors would be more protected from fraudulent organizations as they will be able to reward and punish firms based on the quality of the information provided.

Conclusion of the thesis

Almost ten years since the Enron scandal, and the accounting system is still incomplete. Other scandals like Lehman Brothers or Worldcom still occur. The challenge now is for the regulators body, the IASB and the FASB to tackle the issue. They should provide credible solutions for this major issue. They should improve the framework used by accountants, by imposing stricter rules and by punishing firms who do not comply to these rules.

Accounting manipulation is an international problem, so the two main bodies in accounting, the IASB and the FASB should work together, in case they do not merge into one global accounting body. They should find ways to regain confidence in the accounting system. Either by giving more power to the auditors or by simply changing the ways in which items are reported in the financial statements.

Without their intervention, firms will continue manipulating their earnings, and will continue to trick potential investors. Regulators have the power to ensure the well functioning of the accounting profession and they have the power to change the ways firms prepare their accounts. So it is their duty to regulate the system, in a manner that protects the public from fraudulent firms.

So it is fundamental for these bodies to react, so as to minimize and maybe also, eliminate the chances that firms will in the future, gain advantage of the system for their own benefit at the expense of the investors.

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