

# Creative Accounting, Fraud and International Accounting Standards

Michael Jones  
University of Bristol  
[michaeljohn.jones@bristol.ac.uk](mailto:michaeljohn.jones@bristol.ac.uk)

# 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

# Creative Accounting



©MMI Mike Jones

## *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*

# Definitions

## 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

# Definitions

## 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

# Definitions

## 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

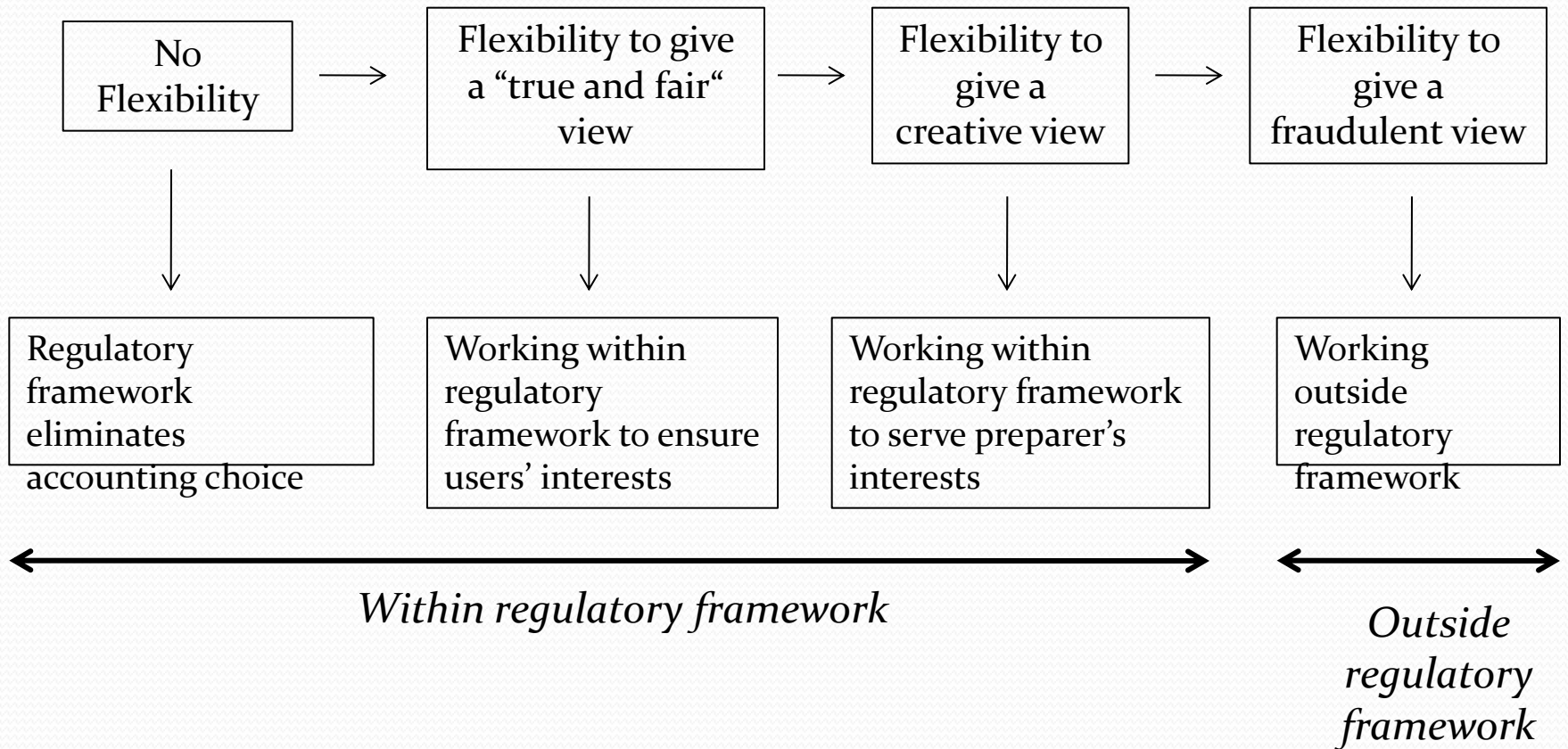
# Definitions

## 4. Fraud

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



# Definitions



# 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
  - 8. P&O , New Zealand, 1917-36
  - 9. Royal Mail Steam Packet Company , UK, 1931

# Accounting Scandals – Across Time

- iv. Twentieth century: Before Second World War (cont.d)
  - 10. Kreuger & Toll, Inc., US, 1932
  - 11. McKesson & Robbins, US, 1937
  
- v. Twentieth century: 1945-1980s
  - 12. Reid Murray, Australia, 1963
  - 13. H.G. Palmer, Australia, 1965
  - 14. Associated Electrical Industries takeover by General Electric Company, UK, 1967
  - 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

<b>AUSTRALIA</b>	<b>GERMANY</b>
Adelaide Steamship Bond Corporation Harris Scharfe One.Tel HIH Insurance	Co-op Balsam Bremer Comroad Flowtex Philip Holzmann Vulkan Verbund
<b>CHINA</b>	<b>GREECE</b>
Shenzhen Yuanye Great Wall Fund Raising Hongguang Daqing Lianyi Kangsi Group Lantain Gufen Zhengzhou Baiwen	Bank of Crete Dynamic Life Esta Finance

# Major Accounting Cases Covered

<b>INDIA</b>	<b>NETHERLANDS</b>
Satyam	Fokker Royal Ahold RSV
<b>ITALY</b>	<b>SPAIN</b>
Parmalat	Afinsa and Forum Filatelico Banesto Caja Rural de Jaen Gescatera Promotura Social De Viviendas
<b>JAPAN</b>	<b>SWEDEN</b>
Fuji Sash Kanebo Livedoor Morimoto-gumi Nikko Cordial  Riccar Sanyo Special Steel Sawako Yamaichi Securities Yaohan Japan	ABB Fermenta Prosolvia Skandia



# Major Accounting Cases Covered

UK	US
Mirror Group Polly Peck Bank of Credit and Commerce International	Adelphia Communications Bear Stearns Bre-X Minerals California Micro Devices Enron HealthSouth Lehman Brothers Madoff Securities International Tyco International WorldCom

# Countries and Authors

Australia	Garry Carnegie and Brendan O'Connell
China	Catherine Chen, Yuanyuan Hu, Jason Xiao
Germany	Hansrudi Lenz
Greece	Maria Krambia-Kapardis, George Kontos, Nikolaos Milonas
India	Bhabatosh Banerjee
Italy	Andrea Melis
Japan	Kazuyuki Suda
Netherlands	Henk Langendijk
Spain	Nieves Carrera
Sweden	Gunnar Rimmel
UK	David Gwilliam, Richard Jackson
US	Charles Mulford and Eugene Comiskey
Bank Failures	Simon Norton

# Six Scandals in Depth

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

# 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

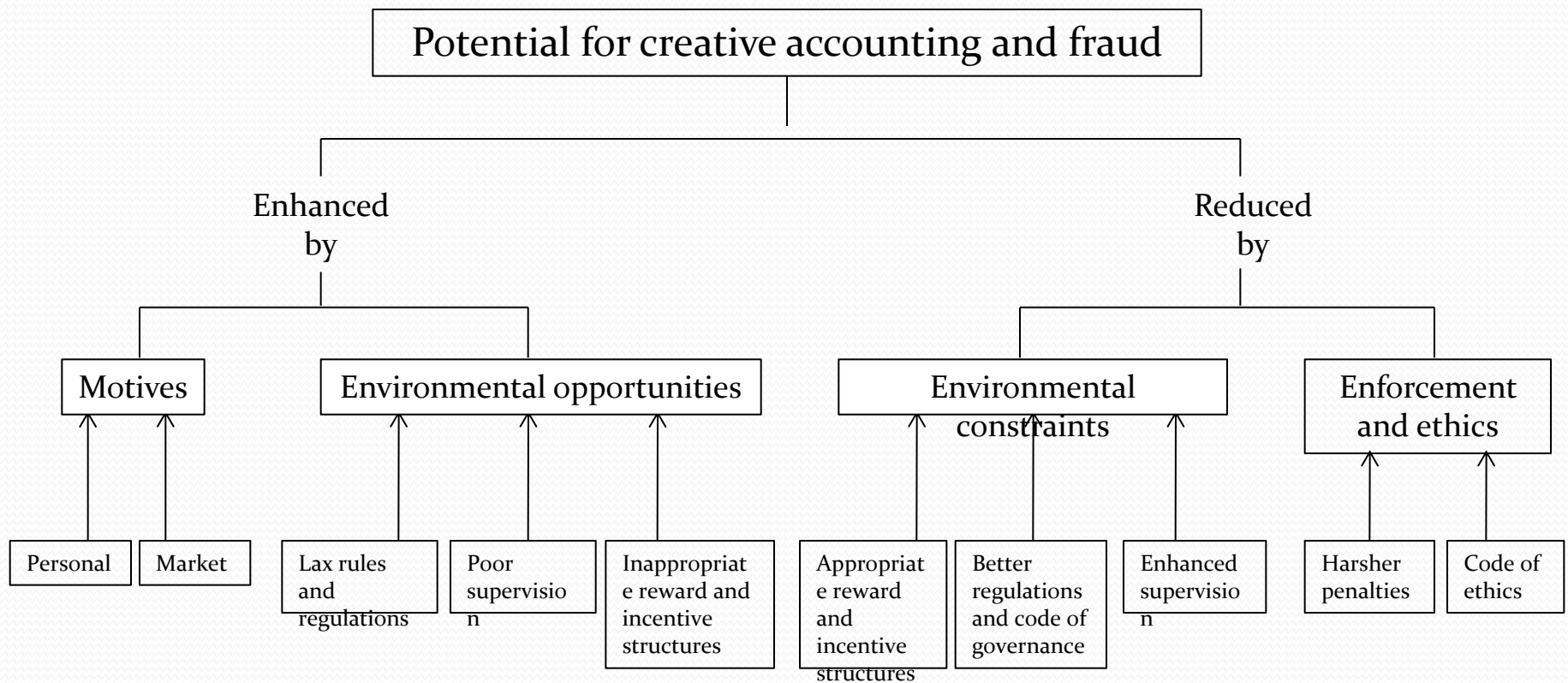
➔ Regulations especially:

- 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



# 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