MISLEADING THE FINANCIAL SITUATION USERS BY FRAUDS

Isa Tak, Assist. Prof., PhD, Lumina - The University of South-East Europe

Abstract: This paper describes the techniques and methods used by the management of an entity that tries and many times succeeds in influencing the financial situations that contain representative fraud. Such methods and techniques that are used worldwide are described in detail as: "creative accounting", "aggressive accounting", "big bath", fraudulent financial situations and "income management". A distinct part of this paper represents the proposals of improving the detection of such actions and the combat against these malefic techniques that have a bad influence on us all, no matter of private users of financial situations or tax and financial authorities.

Keywords: creative accounting, aggressive accounting, "big bath", fraud in financial situations, "income management"

Managers, shareholders, investors and employees have different expectations of different entities, their assets and resources always representing a common interest for the stakeholders above, and according with these assets and resources, different expectations appear. These types of expectations represent the beginning of „made-up" financial situations or that contain fraud.

I. Creative accounting

Accountants worldwide have been criticized so much and so many times for their lack of imagination and rigid attitude insomuch that the term „creative accounting" seems a veritable paradox. Creative accounting, as a concept, is used to describe the process were the knowledge of the professional accountant is used in order to manipulate the amounts in the balance of accounts[1].

In the international literature we find many definitions of creative accounting and I shall itemise the ones I find most important and that are possible to be applied in the Romanian environment. **M. Trotman** defines creative accounting as a technique to communicate a certain type of image of the entity to the investors[2]. **Collase's** opinion is that „creative accounting collocation" represents „practices of accounting information of financial users near the limit of illegality, applied by certain enterprises, that, taking advantage of the rules imposed by the standards, seek to beautify the image of the their financial position and their economic and financial performances".[3]

And yet, the most complete definition belongs to **K. Naser** according to whom „creative accounting" represents:

[1] **Lungu Ionut Cosmin, Potecea G. Valeriu , Rotaru Viorel Horatiu** - Techniques Used in Creative Accounting, Annals of DAAAM for 2009 & Proceedings of the 20th International DAAAM Symposium, Vienna, 2009

[2] **M. Trotman**, Comptabilite britannique, mode d'emploi, Economica Publishing House, Paris, 1993

[3] **Feleaga, N., Feleaga. L.** – *Consolidated accounting*, Bucharest, 2010.

- The process that manipulates accounting figures due to breaches of rules, practices of measurement and the application of information that permit the transformation of documents from what they should be in what the management of the entity desires;
- The process where transactions are structured in such a manner that allows the desired accounting result.

In his study about society collapse, **Agenti** linked the use of creative accounting techniques with the incompetence of entity's management. Incompetent managers concentrate their attention to some particular arrangements and neglect the accounting information system and financial rates, that begin to deteriorate. An entity that is in this stage begins to use creative accounting. The reason is evident, meaning that the entity did not obtain acceptable performances or there might be another reason, that the suppliers do not credit the entity any more, the creditors begin to lower the debts return, customers start working with other entities. By using creative accounting, managers are situated in a defensive position. Their denial of admitting failure is a possible component of a normal psychological attitude, according with „the clouds are going to collide elsewhere".

The specialized literature presents the following reasons that make managers resort to creative accounting:

- Artificial rise of public emitted shares of the entity; if incomes or future cash-in are to follow it is obvious that entity's public emitted shares are going to rise as value;
- Effect of debt costs; if a entity reports high incomes / assets the more trust the banks are showing towards to confer a loan and also low credit rates are to be negotiated by the entity;
- Many times entities remunerate their management according with the achieved financial results; the management is interested in artificially growing these results. Most of the indicators that influence the management remuneration are presented in the financial situations of the entity they manage. This is the reason why managers are always interested in putting pressure on these indicators in order to achieve the desired remuneration or supplementary bonuses.

In this context, managerial accounting tried to develop a theory that limits the influence of management pressure on the financial indicators such as profit, assets, debt and so on. Trying to diversify these values with a series of non-financial indicators, so that reports that are harder to manipulate or create the ways to penalise the management by the investors represents a partial achieve of the objective of „making-up" the financial information.

Other factors that increase **the opportunities of creative accounting to manifest** are: management incompetence, incertitude, risk, variety of economic activities and attitude of financial information users. *The common attribute of the definition above is that creative accounting is a practice that tries to manipulate the financial users*.

Creative accounting has a long and remarkable history. It determined the authors of the accounting standards to be in a continuous process of revising them, due to the increasing abuses of accounting regulations that are used in creative accounting. According with **O. Amat** and **J. Blake** the usage of creative accounting techniques will have the following effect:

- Rise or decrease of costs and incomes; asset diminishing; rise or diminish of debts; rearrangement of assets or debts; manipulation of information presented in supplementary notes of the financial situations.

- The effects are summed up in the figure below:

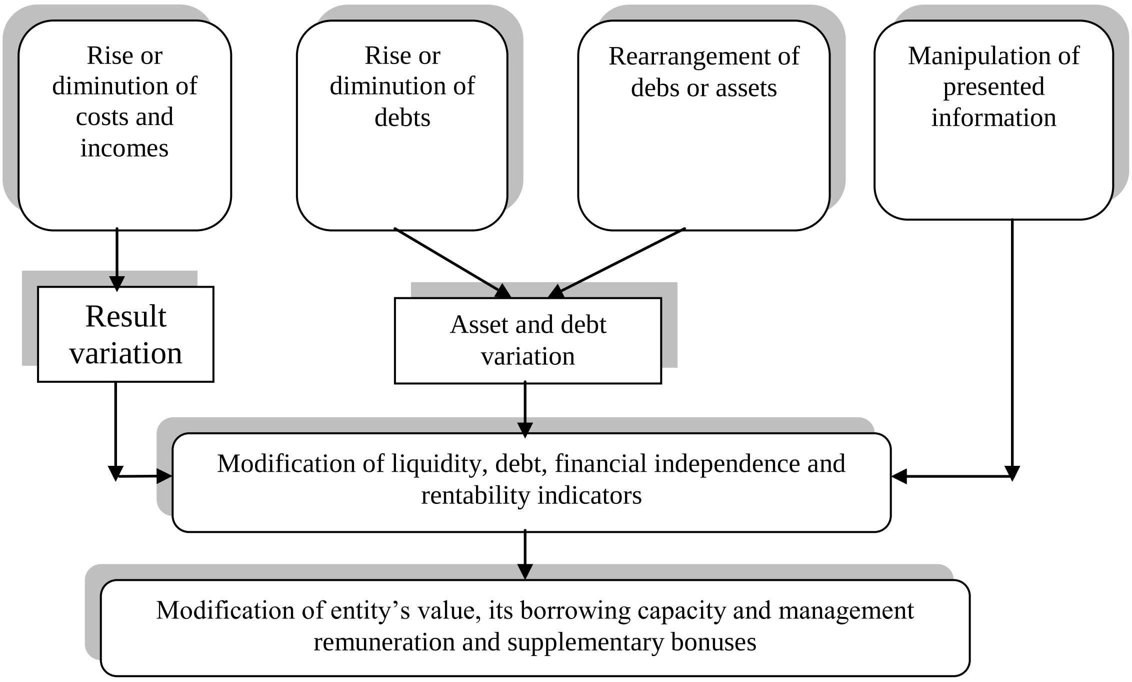

Figure no. 1 – Effects of creative accounting[4]

Creative accounting practices may play an important role of relaxing the restrictive nature of financial agreements. Actions in order to increase the incomes will bring a greater profit, increased current assets and shareholders interest, and in some cases will lower the debts. Because creative accounting is used in order to improve the financial position of an entity and to create protection of current financial agreements, some financial agreements will be less restrictive.[5]

Taking in concern the elements presented, creative accounting assumes that the entity takes advantage of the existent breaches in the standards and of the flexibility of the regulations in order to distort the presented information. Though **there is a clear difference between creative accounting and illegality (fraud), both phenomena appear in conditions of financial difficulty and have as main objective to deceive the financial situation users.** In conclusion, even if creative accounting is not illegal it shows that management, under financial pressure, seeks solutions without regard to ethical standards.

II. Aggressive accounting

Aggressive accounting is generally used in order to obtain a rise of profit in a certain period by applying the accounting standards at the interest of the management. An entity issues invoices but does not deliver the goods or services yet to the buyer and the costs regarding those goods or services are transferred to the following tax period. Accordingly, the entity's incomes rise in the current tax period without any kind of costs.

[4] Ibdem.
[5] **Charles W. Mulford, Eugene E. Comiskey ,** "The Financial Numbers Game" „Detecting Creative Accounting Practices", JOHN WILEY & SONS, INC. Rosewood Drive, Danvers, 2010.

An example of this king of technique used is represented Texun Corporation that, in its annual report announced a corporative restructuration, more precise details about a future economic growth. The stage of cutting costs of the plan included consolidation of administrative positions and reducing the product offer and of inventory conservation. The company also announced the externalisation of commercial activities that were not considered essential any more. The company also registered a pre-taxation of gains for 337.6 billion $ in the fourth trimester of 2009.

A restructuration plan represents a positive event. If this action succeeds it means operation acceleration and cost control being a positive sign for the future of the company. According with GAAP, in the restructuration year, the company should register a restructuration tax and incorporate the anticipated costs of applying this process. Apparently Texsun did so, yet the company intentionally overestimated costs implied in restructuration, fact that brought diminished results in 2009 to greater results in the following tax periods. Texsun applied the principles of aggressive accounting.

In 2009 Texsun due to restructuration tax reported a loss of 285.2 billion $. In 2010, before restatement, the company reported a profit of current activity of 199.4 $. The company was so proud of the reported turnover in 2010 that the Executive Manager, Albert Dunlop had as introduction in his letter addressed to the shareholders the following statement: „We had a great 2010. In the last 12 months we broke new records almost in every aspect of the transactions developed by the company. We registered a significant growth of sales and in the same time of incomes and gross margin. Indeed, the most important aspect is that we succeeded in improving every transaction in the commercial activity”[6]. After the results for that period were rearranged meaning the restructuration tax was removed along with practices of aggressive income recognition, the current gain before tax for 2010 was reduced at 104.1 billion $.

III. „Big bath” practices

The so called „big bath” technique is easy to understand. In the year the entity reports a loss, the management increases that loss by including all future possible losses, that would mean higher gains for the following years. According with an economic perspective, one would be tempted to delay a loss as long as possible and to report a gain as early as possible. The empirical studies have proved that, in some cases, subject are prepared to pay more in order to avoid an unpleasant event rather than the same event in the near future and chose to delay the consumption, meaning more payments for future consumption. Prudence can be valuable because by cancelling it, value could be created.

Restructuring entities „falsify” their financial situations by cancelling assets and by creating substantial debts and irreversible depreciation reserves. The reason behind this technique is that the market ignores cancellation and sometimes observes them as a traditional mean. Exaggerated losses create a shield for future gains. „Big Bath” technique Is applied when there is a change in management and the later management cancels the assets that do not bring profit, registering those assets as costs, in one way to show the lack of competence of the old management and on the other side trying to create a positive and profitable image regarding the future periods of the new management.

[6] **Pedneault, S.**, Fraud 101: Techniques and Strategies for Understanding Fraud, 3rd Edition. Wiley, 2011.

A study developed in the United Kingdom highlighted that 91% of the financial auditors interviewed consider creative accounting as a problem that will never be solved. This means that no matter of the degree of details contained in the standards there will always be a way to „defeat" the system. Consequently, the mission of the standards developers and accounting profession representatives is not a simple one. Even if they are not sure they will win the war against creative accounting, they must make efforts in order to answer to imagination (creative accounting) with imagination (improved standards).

IV. Fraudulent financial reporting

Fraudulent financial reporting implies intentional misrepresentation, including omissions of information contained in the financial situations in order to deceive the financial statements users. The term „fraudulent financial reporting" is used after the fact has been proven by the authorities, in civil or penal law trial[7].

KnowledgeWare Inc., an established Atlanta-based software company was accused by U.S. Securities and Exchange Commission that has fraudulent reported incomes. This company has granted certain clients prolonged payment periods that have doubted the collecting action of its incomes. Those transactions have not been registered in accounting as an income. U.S. Securities and Exchange Commission has mentioned that KnowledgeWare Inc. had as main objective to deceive the financial users by omitting the registration of selling transactions and other documents prepared by the company such as supplementary lists meant to eliminate the possibility for those certain clients to pay.

Fraudulent financial reporting can be achieved by:

- Manipulation, falsification or alteration of accounting information or documents that support the financial situations;
- Misrepresentation or intentional omission of events and transactions that should be contained in the financial statements;

Fraudulent financial reporting most of the time implies avoiding the management controls, in this way internal controls seeming to be efficient. Fraud can be committed by management by avoiding controls using techniques such as[8]:

- Fictive registration of acquisitions in the accounting journals, especially near the end of a period, in order to manipulate current result and to achieve other objectives;
- Adjusting inadequately the forecasts and modifying the judgement used to determine the balance account;
- Omission or delaying the recognition of events and transactions of financial situations that have appeared in the current tax period;
- Hiding or not presenting facts that could affect amounts registered in the financial statements;
- Engaging in complex transactions that are structured in such a manner in order to misrepresent the financial performance of the entity;
- Altering transactions registered or terms regarding significant and unusual events.

[7] **Mulford C. W. - Comiskey E. E.,** The Financial Numbers Game, Detecting Creative Accounting Practices', John Wiley & Sons., 2011.

[8] **Peterson, B. H., P. Smedegaard, W. G. Heninger, M. B. Romney**, Managing multiple identities. Discussion of the benefits, risks, leading practices and audit considerations of both identity and access management, Journal of Accountancy Septembrie, pag. 38-43, 2011.

V. Income management

Income management represents an active manipulation of accounting results with the main objective to create a wrong impression of the economic activity developed. Taking in account that managers can chose which accounting policies to apply of a set of standards, normally one should expect that the management should chose the necessary policies in order to minimise the profit and/or the value of the entity on the market. This technique is „income management" that can be defined as „taking reasonable and legal decisions for financial reporting in order to obtain reliable and predictable financial results". This technique must not be mistaken with illegal activities of fraudulent financial reporting of results that do not reflect the economic reality. These types of activities are known as „fraudulent activities" and imply a wrong presentation of financial statements[9].

The authorities did not reach a conclusion regarding „income management". According to U.S. Securities and Exchange Commission the financial fraud has a larger meaning. Usually, one understands by income management that managers are trying to present the financial situation other than it is, through remaining in the limits of the laws and standards. Though managers are within the limits of law and accounting standards, income management can be converted to fraud according with the management of the entity intentions. There is a thin distinction between fraud and income management, in this context we present;

Specification	**Accounting alternatives according with Generally Accepted Accounting Principles**	**Real alternatives – cash flow**
Traditional accounting	• constitutional elements and reserves at a high level; • each entity can increase the cost level for research, according with legal standards; • cancelling asset registration at a value greater than the real one and restructuration costs.	• income registration delay; • increase marketing and research costs.
Neutral incomes	Profit / gain resulted as a normal commercial activity is developed.	
Aggressive accounting	• constitutive elements registered at a lower level than the standards recommend;	• delaying costs of marketing and the ones for research. • income acceleration.
Fraudulent accounting	(No not meet the recommendations of GAAP) • registering incomes for sales that have never took place; • registering fictive transactions and customers; • changing the information of a transaction of invoices to a prior period; • registering fictive inventory	

[9] **Post James, Lawrence Anne T., Weber, James,** *Business and Society: Corporate Strategy, Public Policy, Ethics,* McGraw – Hill International Editions, Management and Organization Series, pag. 88, 2011.

Figure no. 2 – Difference between fraud and income management

It is obvious that this kind of application is against the accounting standards, with the clear intention of misleading the financial statements users. Dechow şi Skinner[10] highlight that the academic research did not demonstrate that income management has a significant effect of the mean of reported incomes. U.S. Securities and Exchange Commission is concerned about income management because some investors are relying on the amounts reported concerning incomes.

VI. Indications that reveal accounting fraud

Recent research regarding fraudulent financial reports that lead to the collapse of stock market have highlighted the importance that financial reports have but also the understanding of reasons that could lead to appearance of accounting scandals. The collapse of important entities such as Enron (2001), Worldcom (2002), Global Crossing (2002), Parmalat (2003), Societe Generale (2007) have had a negative impression from the public regarding effective corporative management, quality of financial reporting and financial audit functions credibility. These so called fraudulent financial reports have generated major concerns regarding: efficiency of corporate management, integrity and ethical attitude of entity's management, mostly when CEO and CFO are accused of falsifying the accounting registries, acceptibility and efficiency of internal controls; financial audit quality[11].

There are some signs that make one suspect fraud. Some of these are: detection of abnormal situation in case of a detailed investigation; loss of financial documents; appearance of new registered transactions that should not be normally registered or the raise of living standards of some employees. The elements presented above do not represent relevant evidence but represent the beginning of evidence.

The most important factors that influence the risk of fraud appearance and errors are[12]:

a. **deficiencies in projecting and functioning of accounting system and internal control** as I have presented above; that it the reason why these systems represent such a great importance for the financial audit;
b. **management integrity and competence:** the financial auditor analyses a series of conditions that may rise the risk of fraud and errors appearance, such as:

- management is represented by a sole person or a small group, the administration committee functioning inefficiently;
- a fast rhythm of personnel change belonging to accounting and finance departments;
- the prolonged and relevant underestimation of the number of employees belonging to the accounting department.

c. **Unusual pressure in the entity audited** also represents a factor that raises the risk of fraud and error appearance manifested in the following ways:

- the existence of a representative need of profit growth in order to sustain the public emitted stock value;
- investments made in an environment characterised by fast changes;
- entity's dependence in a major way on one or few products or customers;

[10] **Dechow P. M., Skinner D. J.,** Earnings Management: Reconciling the Views of Accounting Academics, Practitioners and Regulators, Accounting Horizons, Vol. 14, Nr. 2, 2011.
[11] **Zabihollah Rezaee,** „Causes, consequences, and deterence of financial statement fraud" page 293., The University of Memphis, Memphis, USA, 2010.
[12] **Power M**, The Audit Society: Rituals of Verification, Oxford University Press, 2009.

d. **Unusual economic transaction** is a factor that can increase the risk of fraud and error appearance and is manifested in the following way:

- the existence of unusual transactions especially at the end of the tax period that influences considerably the accounting and tax profit;

- complex economic transactions developed with affiliated parties;

- payments for services that are expensive in comparison with other services on the same market.

e. **Difficulty in obtaining sufficient and corresponding audit evidence** is a factor that raises the risk of fraud or error appearance; in this context the auditor has to follow:

- existence of inadequate transaction registration, such as: incomplete folders, excessive modification of balance accounts and accounting registries, transactions that are not registered according with the legal requirements;

- registering the economic transaction without an adequate set of documents in order to sustain that transaction, for example: lack of certain authorisations, of accounting documents, documents modification, and so on;

- an exaggerated number of differences between accounting transactions and third parties confirmation.

In the end the financial auditor can also be faced with the situation where the accounting system is digitalised and again the risk of fraud or error appearance is high. The alteration of the accounting software is also possible due to lack of fiscal modification, the software is not approved or tested and also the impossibility to obtain information contained in the files and folders of the software due to a lack of documentation belonging to the software or transaction registration.

Fraud investigation can be very costly and to block fraud is a more serious problem. Generally, people commit fraud due to the following reasons:

- **Pressure,** for example: financial objectives are difficult to achieve, covering both personal and entity's objectives. The employees or management are under pressure when difficult tax periods appear and it is impossible for them to achieve the set objectives. This is the reason for personnel decrease and those that are under pressure because they feel threatened of losing their jobs;
- **Opportunities, favourable occasions,** for example: the personnel cut means there shall be less resources engaged in internal control; financial difficulties, in the context of an economic crises force entities to reduce their costs and explore the segments that generate efficiency. Personnel cut is a way of cutting costs but also weakens the internal control that favours the appearance of fraud;
- **Justification** represents the internal dialogue of the criminal that explains to himself / herself his / her actions. The author of the fraud convinces himself / herself that the employer owes this remuneration.

VII. Opinions, conclusions and proposals

In each entity the success rate of fraud or error detection methods is not 100%. The management of the entity should not even try to offer the chance of financial situations manipulation or corruption to be developed by managers or employees. Fraud cannot be eradicated totally but can be prevented. The more pressure the manipulator has the more excuses he should have. As I mentioned in this paper, the entities should reduce the cost of fraud appearance otherwise there will be problems.

Fraud or errors that manipulate the financial reports have as causes the following elements:

- Lack of entity's management responsibility;
- Inadequate internal control;
- Lack of accounting knowledge of the management;
- Inadequate internal control functions;
- Constant change of external financial auditors or inadequate financial auditors;
- Insufficient credit (both commercial and bank)
- Inadequate economic conditions;
- Lack of cash-in in order to increase the profit;
- Large investments and losses;
- Dependency to more clients.

One can claim that fraud disappearance is an ideal. The final purpose of internal control systems is to reduce the risk of fraud appearance to a certain level that is considered acceptable by the governance or by the owner of the business. In this context I would like to highlight that in order for a financial audit to be successful it must respect the independence principle, meaning that the financial auditor is not responsible for financial situation preparation or internal control application, because, respecting this assumption future misunderstanding with entity's management is to be avoided and they also understand their responsibility in preparing the financial situations and the way the internal control functions, in the same time applying the fair image principle[13].

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