**“Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives”**

A Project Report On

**“Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives”**

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And finally, I like to say that I have tried and soul to prepare this report accurately. However, there might be some errors and silly mistakes due to our aptitude and time constraint. In this regard, I seek your kind consideration and I’m in the process of learning.

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# Executive Summary

The report investigates the cosmetics accounting practices in Developing Countries from Bangladesh Perspective. Cosmetic accounting is a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business.

The introductory part illustrates introduction, purpose statement, and methodology of data collection and limitations of the study. The objectives of the report are to make an analysis of the cosmetic accounting practices in developing countries.

Second part of the report is based on the literature review that different authors had made research on this topic.

Third part of the report is based on the overview of cosmetic accounting. Fourth part of the report is based on the creative accounting in global perspective.  This study expresses the views of External Auditors, Internal Auditors, and the Professional Accountants on causes, techniques, impacts and remedial measures for Cosmetic Accounting.

Fifth part of the report is based on Enron’s fraudulent financial reporting has been analyzed. Here also the emergence of forensic accounting in the detection & prevention of cosmetic accounting has been included.

Sixth & last part of the report contains conclusion & recommendations. Auditors & organizations can use recommendations to identify & remove cosmetic accounting.

# Chapter one: Background of the study

## Introduction

*“Cosmetic accounting is a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business.”*

 “Definitions of creative accounting vary, and include is the deliberate dampening of fluctuations about some level of earnings considered being normal for the firm”. (Barnea et al. 1976)

“Creative accounting is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental”. (Merchant and Rockness, 1994)

Creative accounting consists of accounting practices that follow required laws and regulations, but deviate from what those standards intends to accomplish. Creative accounting capitalizes on loopholes in the accounting standards to falsely portray a better image of the company. Although creative accounting practices are legal, the loopholes they exploit are often reformed to prevent such behaviors.

Cosmetic accounting is not totally objectionable. However, when unethical elements and the motive are wrong, a negative intrusion is the outcome of the accounting details which become unreliable.

The accuracy and reliability of the financial statements are crucial for the stakeholders of the firms in order to make appropriate decisions. This fact has become more important in recent years starting from 2001 by the collapse of Enron and its importance has intensified with the recent financial crisis because of the bankruptcy of major financial institutions. Even if there exist strong accounting standards (GAAP and IAS) to guide financial accounting activities, sometimes it becomes impossible to prevent the manipulative behavior of financial statement preparers, who wants to effect the decisions of the financial statement users in favor of their companies. These manipulative behaviors are often called “creative accounting” and/or “earnings management” “Creative accounting” is the more preferred term in Europe, whereas it more common to use “earnings management” in the USA

## Origin of the Report

This report has been prepared to make a study on the ***“*Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives*”*** as a part of the fulfillment of Project Report required for the BBA program of the School of Business and Economics of United International University.

The report was prepared under the supervision of Dr. James Bakul Sarkar, Assistant Professor of School of Business & Economics of United International University. I am very much thankful to him for assigning me such types of project work.

## Methodology of the Study

For preparing this report, secondary sources data have been used. The secondary sources encompasses books, journals, periodicals, websites, reports and newspaper magazine.

##

## Objectives of the learning

There are two main objectives behind this report:

**Primary (or Academic) Objective**:

The primary objective of the study is to complete the partial requirement of the awarding of the BBA degree from the School of business & economics, United International University.

**Secondary (or study) Objective:**

The main thrust of this study has concentrated on the issues relevant to the Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspective. However, the specific objectives of this study are as follows:

* To overview the concepts of cosmetic accounting;
* To describe the causes cosmetic accounting;
* To describe the techniques of cosmetic accounting;
* To describe the effects of cosmetic accounting;
* To describe motivation for cosmetic accounting;
* To describe how to manage cosmetic accounting;
* To describe the ethical perspective of cosmetic accounting;
* To describe cosmetic accounting from global perspective;
* To analyze the fraudulent financial reporting by Enron Corporation.
* To analyze the emergence of forensic accounting in the detection and prevention of cosmetic accounting.

##

## Limitations of the Study

The limitations of the study are as follows:

* Acquiring the absolute raw data is always a difficult task. However, it can be done in case of large study where lots time can be used.
* The sources of information are limited. As a result, huge data and information could not be calculated.
* Time will be a major constraint in accumulating all sorts of information in an organized way.

Chapter two: Literature Review

## Literature Review:

The concept of creative accounting is usually used to describe the process through which the accounting professionals use their knowledge in order to manipulate the figures included in the annual accounts. Accounting has been defined as “the art of faking a balance sheet” (Bertolus J.), “the art of calculating the benefits” (Lignon M.), “the art of presenting a balance sheet” (Gounin L.), or “the art of saving money” (Ledouble D.).

Karim, Fowzia, & Rashid (2011) analyzed that Cosmetic accounting is a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business. In their study, they expressed the views of External Auditors, Internal Auditors, and the Accountants on causes, techniques, effects and solution for Cosmetic Accounting.

Fagbemi & Olaoye (2014)conducted a study on the scrutiny of the international scene over the past ten years has revealed various cases of corporate failure, facilitated by fraudulent manipulation of accounts by managers and with the implication of accountants in some instances. This manipulation is often referred to as cosmetic accounting. These cases have necessitated the examination of the consequences of these fraudulent practices. The study obtained primary data from accountants in Nigeria. Findings from the study show that respondents are aware of cosmetic accounting and that it is unethical. The results also indicate that the investors suffer as a result of decisions made using a doctored financial statement. Evidence also exist that management and auditors of corporate enterprises have a role to play in ensuring high business and ethical standards in order to guide against cosmetic accounting.

Diana & Mdlina (2008) analyzed the manipulation of financial information which is called by several terms such as earnings management, income smoothing, creative accounting practices, aggressive accounting or account manipulation, prevents the allocation of resources in the most efficient areas in the economy. The scope of this paper is to relate the causes, the main motivations behind their application, the objectives, the methods and the consequences of manipulation in financial reporting. Creative accounting is not a new technique, but it can be seen as a costly one. Businesses feel the pressure to appear profitable to attract investors and resources, but deceptive or fraudulent accounting practices often conduct to drastic consequences.

B. (2014) examined “the effect of creative accounting on the Nigerian banking industry with the purpose of determining the motive behind the practice of creative accounting in the Nigerian banking industry, to ascertain whether creative accounting has contributed to banks’ distress in Nigeria, and to examine measures that could curb the practice in the Nigerian banking industry. Primary source of data collection was employed in this study and statistical tools used to analyze the data were the Kruskal-Wallis test and the multiple bar chart analysis. The result of this study revealed that the major reason for creative accounting practices in the Nigerian banking industry was to inflate the operating costs to reduce exposure to taxes. It was further found that other key reasons for creative accounting practice in the Nigerian banking industry include: to help maintain or boost the share price by reducing the apparent levels of borrowing, making the company appear subject to less risk and of a good profit trend , to inflate the amount of operating costs in order to reduce exposure to taxes, to report a steady trend of growth in profit, rather than slow volatile profits with a series of dramatic rises and falls, and to effect changes in accounting policies in order to discourage findings faults in the company’s accounting system. It was observed that that creative accounting has significant impact on banks distress in Nigeria and it was further observed that effective measures can curb the practice of creative accounting in the Nigerian banking industry.”

Chapter Three: Overview of Creative Accounting

## Concept of Cosmetic Accounting

Creative Accounting refers to the use of accounting knowledge to influence the reported figures, while remaining within the jurisdiction of accounting rules and laws, so that instead of showing the actual performance or position of the company, they reflect what the management wants to tell the stakeholders. The preferred term in the USA, and consequently in most of the literature on the subject is ‘earnings management’, but in Europe the preferred term is ‘creative accounting’ and so this is the term that will be used in this paper. It should be recognized that some accounting manipulation involves primarily balance sheet rather than earnings management. Definitions of creative accounting vary, and include the following:

“Purposeful intervention in the external financial reporting process with the intent of obtaining some exclusive gain”

“Is the deliberate dampening of fluctuations about some level of earnings considered being normal for the firm”.

“Is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental”.

“Creative accounting is the transformation of financial accounting figures from what they actually are to what preparer desires by taking advantage of the existing rules and/or ignoring some or all of them”.

Schipper (1989) observes that ‘creative accounting’ can be equated with ‘disclosure management’, in the sense of a purposeful intervention in the financial reporting process.

Many terms can be used to describe the practices of changing the facts in accounting, e.g. cooking the books, aggressive accounting, massaging the numbers, window dressing, earnings management, etc.

|  |  |
| --- | --- |
| **Label** | **Definition** |
| Aggressive Accounting | A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with GAAP or not |
| Earnings management | The active manipulation of earnings toward a predetermined target, which may be set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream |
| Income Smoothing | A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and “store” profits during good years for use during slower years |
| Fraudulent financial reporting | Intentional misstatements or omissions of amounts or disclosures in financial statements, done to deceive financial statement users, that are determined to be fraudulent by an administrative, civil, or criminal proceeding |
| Creative accounting practices | Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earning |
| *Source: The Financial Number Game by Charles W. Mulford& Eugene E. Comiskey, 2002 (John Wiley & Sons)* |

## Techniques of Creative Accounting

In this section techniques used for creative accounting and/or earnings management will be explained based on different studies in the literature.

* **Recognizing Premature or Fictitious Revenue:** Premature revenue recognition and fictitious revenue recognition differ in the degree to which aggressive accounting actions are taken. In the case of premature revenue, revenue is recognized for a legitimate sale in a period prior to that called for by generally accepted accounting principles. In contrast, fictitious revenue recognition entails the recording of revenue for a nonexistent sale. It is often difficult, however, to assign a label to such revenue recognition practices because of the large gray area that exists between what is premature and what is fictitious revenue recognition.

Examples:

- Revenue recognized for goods that have been ordered but that have not been shipped at the time of recognition would be considered by most to be premature.

- Recording bill-and-hold sales transactions or other indications that sales are recognized in advance of shipment

- Recognizing conditional sales depending on the availability of financing, resale to third parties, final acceptance, performance guarantees, and further customer modifications

- Overstating percentage-of-completion revenues when there are uncertainties about the bona fides of the underlying contract

- Improperly recording sales returns and allowances

* **“Big Bath” Accounting:** One of the hardest accounting frauds to spot is big bath accounting. When a company is doing really bad and has no chance of meeting earning expectations, unscrupulous management would begin writing-off every expense and asset they could imagine. As a result, future expenses are reduced significantly and naturally earnings increase. In other words, the company is taking a big bath in the worst year so it can wipe its slate clean. This almost always guarantees record-breaking earnings in subsequent years, likewise performance bonuses.

In a big bath, management would write-down substantial assets, that don’t occur under normal operating conditions, in order to maximize future benefits. So, pay close attention to special one-time charges. Sale of discontinued operations, accelerated depreciation of inventory, plant and equipment, write-off of an investment gone south and restructuring charges are some of the most common one-time charges.

At one end of the spectrum, recording reasonable one-time charges before the end of the year for tax benefits is legal and could benefit shareholders. This is akin to investors selling our losers at the end of the year to lock in the tax benefits to offset profits next year. At the other end of the spectrum, writing off everything you can imagine with the goal of locking in huge performance bonuses in subsequent years is just plain evil.

Example:

In 2001, Cisco wrote off more than $2 billion in inventory even though some of the inventory was not worthless and would be sold in the future, thus resulting in pure profits from these future sales.

* **Using Cookie Jar Reserves:** "Cookie jar" is slang for a reserve of cash that is not disclosed on a company’s financial statements, or that is listed as funds earmarked for a liability that does not currently exist. Cookie jar accounting is used to create such cash reserves in good years so the money can be used to offset poor earnings in bad years. The effect is to give the impression the company is consistently achieving earnings goals and meeting investor expectations.

A common form of cookie jar accounting is to “recognize” or state a liability when the company in fact has not incurred a liability. For example, company executives may say they plan to reorganize or restructure the firm. The estimated cost of restructuring is then listed as a liability, and money is deducted from stated earnings. Suppose Company X earns $1.5 million. Executives say they are going to restructure the company at a cost of $500,000. This amount is listed as a liability, reducing earnings to $1 million. The next year is not a good one and profits fall to $600,000. The executives announce they have canceled the restructuring, eliminating the supposed liability. The $500,000 is then listed as income, inflating the company’s net earnings to $1.1 million.

Example:

In 2010 Dell Computers settled allegations of cookie jar accounting with the Securities and Exchange Commission for $100 million. According to the SEC, Dell made an agreement with Intel Corporation in which Dell used Intel microchips exclusively in return for payments by Intel. Dell executives failed to disclose the payments to investors. The SEC found that Dell had failed to meet earnings targets every quarter from 2002 to 2005, and used the undisclosed exclusivity payments to make up the shortfalls.

* **Aggressive Capitalization and Extended Amortization Policies:** Cost capitalization that stretches the flexibility within generally accepted accounting principles beyond its intended limits, resulting in reporting as assets items that more reasonably should have been expensed. The purpose of this activity is likely to alter financial results and financial position in order to create a potentially misleading impression of a firm's business performance or financial position. One alternative way for companies to reduce expenses is aggressively capitalizing expenditures that should have been expensed. Although determination of the portion fan expenditure to capitalize is straightforward in many cases, items as direct-response advertising and software development costs require judgment in determining whether capitalization is appropriate or not. To lengthen amortization periods for costs that have been capitalized previously is also used to reduce expenses and boost earnings.
* **Manipulating Inventory:** Firms can engage into inventory manipulation by either manipulating the quantity of the inventory or by valuing it. In years when profits need to beincreasedthequantitycanbemanipulatedbydoingaparticularlyrigorousstock-take. Provisions for absolute and slow-moving inventory and changing the actual method of inventory valuation are the practices of manipulating inventory values.
* **Abuse of Materiality Concept: “**It includes misusing the concept of materiality by intentionally recording errors within a defined percentage ceiling. Firms indulging in this practice try to find an excuse for it by arguing that the effect on the net income is too small to matter.”

## Causes of Cosmetic (Creative) Accounting

The real causes of creative accounting lie in the conflicts of interest among different interest groups. Managing shareholders’ interest is to pay less tax and dividends. Investor-shareholders are interested to get more dividends and capital gains. Country’s tax authorities would like to collect more and more taxes. Employees are interested to get better salary and higher profit share. But creative accounting puts one group or two to advantageous position at the expense of others. Earnings per share (EPS), the only number to which investors often go wrong by paying too much attention, can be ‘boosted by the stroke of an accountant’s creative pen.’ Schiff (1993: 94-95) has mentioned six of the many ways: “companies can goose their earnings: (1) hidden pension liabilities, (ii)capitalizing expenses instead of writing them off, (iii) receivables or inventories growing faster than sales, (iv) negative cash flow, (v) consolidating owned

Subsidiary’s income and net worth, with the impossibility of receiving the same, and (vi) following seemingly conservative practice in a situation of reverse.”

## Effects of Cosmetic Accounting

The obvious effects of creative accounting are as follows:

1. There are companies listed on the stock exchange, which show inflated profit and better financial position in their cosmetic accounting statements to attract investors; this creation of accounts just misguides and creates confusion.
2. Some company prospectuses may not always depict the reality of the financial positions of the listed companies and firms.
3. Processes adopted for created cosmetic accounting statements may hold out untrue hopes to investors for a shorter period but cannot continue to succeed for a longer period.
4. Ultimately, the concerned companies listed in the stock exchange collapse and the investors lose confidence in them and gray market.

## Motivation for Cosmetic Accounting

Cosmetic Accounting helps in structuring of transactions such that the desired accounting results are produced. The actual impetus for creative accounting is the conflicting interests of various stakeholders. Managers wish to pay least amount of taxes. Board of Directors wish to pay minimum dividend, whereas shareholders want maximum dividends. Employees want high salaries, directors require high profit share, Government wants to collect more taxes. Creative Accounting places one or two groups into advantage, naturally at the cost of the others. David Schiff (1993-94) has warned the investors that taking a organization’s financial statements at face value can be “recipe for disaster”.

The figure depicts the motivational framework for the increasing use of creative accounting. The framework clearly defines three segments i.e. Stakeholders, Motivational factor and techniques for creative accounting. The set of stakeholders want to manipulate/misrepresent the financial statements to meet their own selfish interest. It has also been observed that environmental conditions like voids in regulations, multiple accounting practices, flexibility to alter transactions, flexibility to redefine asset and liabilities etc. are instrumental in the occurrence of creative accounts. Following paragraphs indicate the different segments of the framework.

The **promoters and shareholders** wish to maximize their wealth and profits respectively but promoter wants to tamper with the financial statement to prevent large distribution of dividends or to minimize taxes. The shareholder although desires to maximize his wealth but is not able to forego the dividends because one in hand is always better than 2 in the bush.

Now comes the Board of Directors and Employees. Executives pay-out is directly linked to their performance. So, to maximize their current performance they manipulate with timing of transactions, valuation of assets and inventories, debts, loans etc. in the Balance Sheet. Similarly, employees fidget with various transactions and operations to showcase their outstanding performance, hence creativity in accounting.

Creativity is also present in National Accounting. Governments in every part of the world are even not an exception to the use of creative accounting. Government uses Creative Accounting for scenarios. Showing good economic growth, healthy market conditions, hence attraction for foreign investors resulting in social, economic, infrastructure growth in the country hence motivated public and a solid vote bank. Disguise surpluses; show off a worrisome national growth to impose a need of lowering planned expenses and raising tax burden. This may lead to increased surplus and larger foreign aids over time.



##

Figure 1: Frameworks for Creative Accounting

|  |  |  |  |
| --- | --- | --- | --- |
| Playing with Regulation | Playing with Transactions | Playing with Asset and Liabilities | Playing with Accounting Std. |
| Capitalization of research and development costs | misrepresenting certain expenses in the asset production or purchase cost | manipulating depreciation costs and calculations | adjusting with branch accounts and miscalculating consolidated accounts |
| Switching over from one depreciation technique to other across years and assets. | Faulty representation of future transactions. | tampering with methods of depreciation, their durations and residual values | Creating extraordinary results (sales of fixed assets, costs or revenues from previous years) |
| Circumstantial placement of bonds warrants and convertible shares and debentures as per the whims and fancies of the management. | Fictitious sales | no definite criteria for selection of assets and their timings for revaluation | considering extraordinary results as ordinary and vice versa |
| Variations in inventory valuation methods. | Price falsification for inter and intra company transactions. | Variation in inventory valuation methods. | Adjusting revenue recognitions and expense estimations with a negative intention. |
|  | Fluctuating prices of your holdings to impact the internal capital and profits. | knocking off assets with liabilities or expenses with revenues | misappropriation of the commercial funds against reserves or capitalization and depreciation |
|  |  | Changes of the holdings classification policy | certain accounting expenses not included in the profit and loss account instead shown in retained earnings |
|  |  | Valuation of intangible Assets |  |

## Managing Cosmetic Accounting

It is not possible to eradicate creative accounting and there is no need for it also. Every firm has the right to present itself beautifully, so no harm in topping up the financial numbers. If this is wrong then probably no beauty product producer should showcase film stars in their advertisement campaigns, no energy drink should be endorsed by sportspersons, no pharmacy products are legitimatized by doctors and so on. But as far as creative accounting is concerned, all should be done under the umbrella of a governing body that can demarcate the difference between creativity and fraud. Surveillance committee or tribunals who have power to punish and penalize the culprit under the supervision of the high court be formed. Such committees have to be independent of the supreme regulatory body (ICAI in this respect) to control created accounts. Secondly the financial statements need to have an attached disclaimer. Hence financial figures need to be supported by complete set of information keeping thorough transparency in mind. Thirdly ethics need to be reinforced repeatedly at all levels starting from the education at basic accounting level to highest levels like that of a chartered accountant or a company secretary. Fourthly, every business entity should have significant depth of IT adoption and maturity of the IT system to capture maximum information from transactional level activities, followed by absolutely no manual intervention. If this is implemented completely, creativity on the part of the accountant/manager would be almost zero, hence minimal window dressing.



Figure 2: Creative Accounting Minimizing Framework

The suggestive framework to minimize the creative accounting has three zone of consideration: **Theoretical Foundation:** The pillars of the framework are the theoretical foundations derived from existing accounting theories and practices. The first pillar is harmonization. Harmonization of the existing GAAP, the accounting standards followed across the globe and the laws of various countries where organizations operate their business. The second pillar is Control. Control towards a hyper active and sensitive system over both, the business on one hand and accounting professionals for prompt and real time exposition on the other. The third pillar is for assured and absolute independence of auditors (which still is a myth in a country like India). **Enablers** are the means to achieve the theoretical expectations by focusing over functional areas. To reemphasize, theoretical foundations are the basic set of thoughts which have been proven time and again by numerous scholars in the field of accounting. These can be achieved by having a sound regulatory framework through strong IT support and firm implementation of code of ethics. Creative Accounting needs to be monitored rigidly not only for the safety of the interests of the external users but also from the wish to make the business sustainable and safe. So, the initiators should be regulatory bodies and companies. The role of the company (top management) should be the strongest because when a scandal comes into picture, the company’s safety, rather very existence blurs.

**Functional Area** is the major focus areas which need to be looked at minutely. A check on these areas can be very instrumental in controlling creative accounting and its negative impacts. Here three major areas have been identified. They are administrative, information and process governance. The governance at the administrative level should be highly motivating for the employees. They should be inculcated with a feeling of ownership for the firm so that they are morally bound to not to indulge in unfair accounting practices and report the same intelligently. More and more individuals should be involved in administration to dilute wrongful teaming. Informational governance deals with stringent control of accounting information such that no data tampering is possible. In a way information once fed is blocked from being modified at any level. This will also include process governance. The process governance focuses over developing and maintaining a industry/sector wide common approach for the set-up of roles, activities and processes for accounting and reporting Purpose, setting up escalation body for scoping responsibilities and activities for accounting related processes, align and set up common approaches to achieve Accounting objectives, define and maintain processes relevant to preparing financial statement.

##

## The Ethical Perspective of Cosmetic Accounting

“The ethics of bias in accounting policy choice is reviewed at the ‘macro’ level of the accounting regulator. This can similarly be applied to the bias in accounting policy choice at the ‘micro’ level of the management of individual companies that is implicit in Creative Accounting. If we consider the position taken by Ruland (1984)and compare it to Ravine’s analysis, we note that Ruland distinguishes between the deontological view, whereby moral rules apply to actual actions, and the teleological view that an action should be judged on the basis of the moral worth of the outcome. Revsine (1991) appears to take a teleological view of accounting in the private sector, allowing managers to choose between the alternatives permitted in “loose “standards to achieve their desired end, but to make a deontological view of accounting in the public sector where he calls for tighter standards to prevent such manipulation. We might ask whether the presence or absence of market discipline justifies such ethical inconsistency. Ruland also discusses the distinction between a ‘positive’ responsibility, which here would be the duty to present unbiased accounts, and a negative, responsibility, where managers would be responsible for states of affairs they fail to prevent. Thus, Ruland gives priority to the positive. Within Revsine’s framework, where all outcomes are deemed to be impounded in the process of contracting and price-setting, the distinction is not acknowledged. The ‘duty to refrain’ would imply avoiding the bias inherent in creative accounting while the ‘duty to act’ would involve pursuing the consequences to be achieved by creative accounting.”

To the professional accountant, “creative accounting generally seems to be regarded as ethically dubious. In the USA, the then senior partner of price water house coopers Conner observed. “When fraudulent reporting occurs, if frequently, is perpetrated at levels of management above those for which internal control systems are designed to be effective. It often involves using the financial statements to create an illusion that the entity is healthier and more prosperous than it actually is. This illusion sometimes is accomplished by masking economic realities through intentional misapplication of accounting principles” (Conner, 1986).In Australia, Leung and Cooper (1995) found that in a survey of 1500accountants, the three ethical problems cited frequently were conflict of interest, client proposals to manipulate accounts, and client proposals for tax evasion.

|  |  |
| --- | --- |
|  | **% of Respondents** |
| Conflict of Interest | 51.9 |
| Client proposal to manipulate accounts | 50.1 |
| Client proposal for tax evasion | 46.8 |

Source: Leung and Cooper (1995) – “Ethical dilemmas in accountancy practice” pp.28-33.

The survey of attitude to creative accounting in the USA both highlight a difference in accountants, “attitudes to creative accounting depending on whether it arises from abuse of accounting rules or from the manipulation of transactions. Fischer and Rosen Zweig (1995) found that accounting and MBA students were more critical than accounting practitioners of manipulated transactions, where as accounting practitioner were more critical than students of abuse accounting rules. Merchant and Rockness (1994) similarly found that, when presented with scenarios of creative accounting accountants were more critical of abuse of accounting rules than of manipulation of transactions. Fisher and Rosen Zweig offer two possible explanations for accountants’ attitudes. First, accountants may like a rule-based approach to ethics, rather than on the impact on users of the accounts. Second, accountants may see abuse of accounting rules as falling within their domain, and therefore demanding their domain, and therefore demanding their ethical judgment, while the manipulation of transaction falls within the domain of management and so not subject to the same ethical code. Merchant and Rockness also found a difference in accountant’s attitude to creative accounting depending on the motivation of management. Creative accounting based on explicit motives of self- interest attracted more disapproval than where the motivation was to promote the company. An accountant, or other manager, who takes a stand on creative accounting faces the same pressures as any other whistle blower, in extreme cases failure to act could ruin a reputation.” As one company accountant who took a firm stand put it. “It cost me my job, but I don’t think I would have gotten another job, had I been unethical” (Baldo, 1995).

## Chapter Four: Cosmetic Accounting from Global Theory and Practice of Perspective

## Cosmetic Accounting from Global Theory and Practice of Perspective

Creative accounting seems to be widespread globally. “The difference is possibly in the degree and technique. Several years back in the United Kingdom, Westminster and Midland Banks were in controversy regarding treatment of write-offs as extraordinary or exceptional items. The Midland Bank wrote off its substantial LDC less developed countries’ (LDC’s) lending as “below-the line extraordinary item”, thereby ensuring that its operating results and earnings per share remain unaffected. On the other hand, the Westminster bank’s treatment of its equivalent item was to disclose it separately as “above-the-line exceptional item” to arrive at its operating results. However, both treatments did not conform to the criteria of revised UK accounting standards – SSAP 6, requiring their audits, ironically the same Ernst & Whinny, to face a barrage of pointed questions, as well as a tribunal of the professional standards committee. This is ahistorical fact presented as a matter of reference only.”

Creative accounting resulting in fraud may sometimes be so masked as to escape detection even by auditors applying the strictest rules of professional practice. A good example that illustrates this was the experience of Ferranti International Signal and its USA subsidiary, International Signal Control (ISC) Technologies .

“Ferranti International had acquired ISC Technologies in September 1987 for £420 million sterling, based on accounts that have been audited by KPMG Peat Marwick McLintock, who were unaware of an alleged fraud of £215 million sterling in the company. The fraud involved three non-existent arms deals in Pakistan, China and Nigeria, through payments made to a network of companies in Panama and Switzerland who, purportedly, were sub-contractors to the deals. Some of the money was recycled to the company’s United States subsidiary as if the contracts were real. The effect of this was to inflate the assets and profits of the subsidiary, which, as a result, showed a net worth of US$320 million, whereas the company had absolutely no net worth. Ferranti International suffered because it paid £420 million sterling to acquire a company that was worthless at the time of acquisition. In other words, Ferranti International paid £420 million sterling to acquire net assets that did not exist” (Financial Times, November 17, 1989).

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Another recent case in the USA like Enron is that of American International Group (AIG) which surfaced in the winter of 2004 (“Accounting for the abuses at AIG”). According to the article, “AIG directors acted as if the company's very survival was at stake, removing Maurice Greenberg as CEO and later forcing him to step down as chairman. According to press reports, the tipping point came when directors and regulators learned that documents might have been removed from an AIG building or destroyed. New York Attorney General Eliot Spitzer then threatened criminal charges against AIG itself. No major financial firm had survived such a blow”.

# Chapter Five: Findings

## Fraudulent Financial Reporting of Enron

**Fraudulent financial reporting** is a deliberate misstatement or omission of financial accounting information intended to deceive the investors. Most instances of fraudulent financial reporting involve overstatements of assets or revenues, understatements of liabilities, or failures to disclose information. Enron management committed following types of financial statement fraud:

1. Improper Revenue Recognition
2. Undervaluation of Liabilities
3. Hedging Activities
4. Mark-to-Market Accounting
5. Non-disclosure of Material Information
6. Improper accounting practices

**Improper Revenue Recognition:**

Many of the transactions between Chewco, JEDI and Enron did not seem to have an underlying economic rationale and seemed to have been entered into with the sole purpose of accelerating revenue recognition at Enron. A brief descriptive of some of these transactions has been provided below:

1. “Enron guaranteed the loan from Barclay’s bank it charged a loan guarantee fee. As a result Chewco had to pay Enron 17.4 million as a Guarantee Fees for Enron’s guarantee to Barclays. Later, this fee was classified as a structuring fee of $17.4 million of which $10 million was recognized immediately (in 1997), with the remainder recognized in early 1998. First, it is unclear as to why JEDI had to clear Chewco’s liability. Secondly, the fee did not take into account any of the transaction risk dynamics. Lastly, Enron recognized these transactions as “structuring fees” and took these into income up-front instead of amortizing these payments over the period of the guarantee.”
2. As per contract “JEDI had to pay Enron an annual management fee of the greater of 2.5% of $383 million or $2 million. The fee was payable through 2003. In 1998, Enron restructured the contract & termed these management fees as a “required payment” to Enron. Enron recognized the payment of $25.7 million immediately as revenues in March 1998. This was improper due to the following reasons: the payments were made for services to be rendered by Enron to JEDI over 1998-2003 and it was incorrect to recognize the fees one-shot before even the services were rendered.”
3. JEDI held 12 million shares of Enron stock and accounted for all its assets under the fair value method. Therefore, any appreciation in value was taken as unrealized gains into its income statement. During the period when Enron stock’s was appreciating, JEDI recognized significant gains. Enron, which accounted for JEDI under the equity method, took gains on appreciation of its own stock! While the exact amount is unclear, it looks like $126 million was taken in one quarter during 2000. What is surprising is when the stock lost value in 2001, Enron did not recognize its share of loss that amounted to $90 million.

## Undervaluation of liabilities

“Special purpose entity Chewco was formed primarily to keep debt off Enron’s balance sheet. Chewco, a limited partnership formed in 1997, was the first time that Enron used an SPE run by an Enron employee to keep transactions off Enron’s financial statements. The partnership referred to involve a $500 million equal joint venture between Enron and the California Public Employees’ Retirement System (CALPERS) during 1993-96 called the “JEDI”. Given that Enron wanted CALPERS to participate actively in a new JEDI II partnership, Enron had to buy-out CALPERS and find a new limited partner. Enron put together a bridge financing arrangement under which Chewco could raise $383 million (to pay CALPERS) in the following manner: (1) a $250 subordinated loan to Chewco from a bank that was guaranteed by Enron (2) a $132 million revolving credit arrangement between LJM and Chewco and (3) equity contribution of $11 million by Chewco though the source of this was unclear. Notwithstanding the fact that there was no equity but just debt, Enron chose not to consolidate the transaction in its accounts. Thus, Enron keep debt off from Enron’s balance sheet.”

## Hedging Activities

Following are two examples:

1. **Talon and Avici**: “Talon was used to hedge Enron’s investment in Avici Systems, Inc. (Avici), an Internet architecture firm. Enron owned a large share of the company’s stock and on September 15, 2000 it entered into a total return swap with Talon on Avici stock. At that time Avici traded for about $95.50 a share. However, the swap agreement was dated as of August 3rd. This was also the day on which Avici stock traded for $162.50 per share, it’s all time high. By September 30 when Avici had dropped to $95 a share, Enron offset $75 million in losses as a result of the swap.”
2. **Porcupine and TNCP**: “Enron and Porcupine entered into a total return swap on $18 million shares of TNCP stock at $21 a share. This enabled Enron to lock in a gain on its transactions with Hawaii 125-0 in the amount of $370 million.”

## Marked-to-Market Accounting:

By the fall of 2000, Enron was starting to crumble under its own weight. CEO Jeffrey Skilling had a way of hiding the financial losses of the trading business and other operations of the company; it was called mark-to-market accounting. This is used in the trading of securities, when you determine what the actual value of the security is at the moment. This can work well for securities, but it can be disastrous for other businesses. Some of the examples of Enron’s mark-to-market accounting transactions have been given below:

1. “Lower demand for movie rental business through Enron broadband business lead to the termination of the pilot project partnership between Blockbuster & Enron. Enron decided to monetize the loss & entered into a new second partnership with CIBC World Markets. CIBC paid $115.2 million & Enron recognized $110.9 million as profit for the 4th quarter of 2000 and the 1st quarter of 2001. This sharply reduced the losses Enron had to recognize from the fiber-optics division.”
2. Enron had invested $10 million in the company and over one year starting March 1998, Enron’s investment value reached a peak of $300 million. Though management’s ability to sell the stock was constrained by a lock-up agreement, it was surprising that Enron accounted for the stock as part of its trading portfolio and took the unrecognized gains into its income statement through a mark-to-market on the investment.
3. Enron owned 65% of EPE, a Brazilian company and had control over the appointment of three out of four persons on the Board of Directors. When the company wanted to reduce its stake in this company, there were no takers. Of course, there was always LJM1 to help out: LJM1 bought a 13% stake in the company plus the right to appoint a director on the board for $11.3 million. Also, LJM1 was guaranteed a return of 13% or 25% depending on when Enron could find another buyer to bailout LJM1 from its investment. Thereafter, Enron wrongly claimed that it no longer exercised control over EPE and did not have to consolidate this investment as a subsidiary; this line of reasoning permitted Enron to recognize mark-to-market gains (on what should have been eliminated as inter-corporate transactions) with EPE amounting to $65 million in 1999.

**Non-disclosure of material information**

1. From 1993 through 1996**,** Enron and the California Public Employees**'** Retirement System ("CalPERS') were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership("JEDI'). Because Enron and CalPERS had joint control of the partnership**,** Enron did not consolidate JEDI into its consolidated financial statements. The financial statement impact of non-consolidation was significant: Enron would record its contractual share of gains and losses from JEDI on its income statement and would disclose the gain or loss separately in its financial statement footnotes, but would **not** show JEDI's debt on its balance sheet.
2. Both the LJM1 case and the LJM2 case raise significant corporate governance issues. Unlike Kopper, Fastow was a senior employee of Enron and the argument that can be put forth is that if he controlled LJM1 and LJM2, it could be presumed that Enron controlled both entities that would require consolidation. Whether Fastow, in fact, controlled the two entities is a moot point. The fact that an individual is a general partner cannot lead to the assumption that the general partner controls the partnership, especially where the general partner’s investment authority is limited by limited partners and the latter could resolve to remove the former. Considering that there were limitations on Fastow’s role as a general partner, there could be arguments for and against consolidation.

**Some other improper accounting practices that lead to financial statement fraud:**

1. Enron had a forward contract with an investment bank to purchase its own stock and given the appreciation in the stock price, the contract was in-the-money. Since a company is not allowed to recognize the gain in appreciation of its own stock, Enron’s management hitched upon a plan to realize the appreciation in value through LJM1 (by transferring restricted stock to the latter) in exchange for a note receivable.
2. In 1999, LJM1 paid Enron $64 million plus interest. It is unclear how LJM1 was able to pay this amount to Enron when it had equity of only $16 million. Further, in September 1999, LJM1 had purchased an interest in Cuiaba for $11.3 million. It is unclear whether LJM1 sold the shares transferred by Enron in violation of the agreement or obtained loans using the shares as collateral.
3. There were several incorrect aspects associated with the Ryth hedge liquidation: Firstly, the Board of Directors was unaware of these transactions and no internal approvals were obtained for the unwinding. Secondly, given the four-year sale restriction on the Enron shares, it was highly improper that the shares were valued on an unrestricted basis; assuming a discount (due to the sale restriction) and amortizing the discount for the period from June 1999 till March 2000 on a straight-line basis, $72 million of discount would have been left-over. Consequently, the shares returned by Swap Sub would have been worth only $162 million while Swap Sub received $234 million, an amount in excess by $72 million. Andersen raised no questions as to the unfair valuation of the returned shares.

## The Emergence of Forensic Accounting in the Detection & Prevention of Cosmetic Accounting

Regardless of the term accounting in forensic accounting, the discipline isn’t related to simply reading financial statements that are available to the public or dealing with other accounting issues; the usual accountants, portfolio managers, investment analysts, etc. already do the regular financial tasks. Instead, forensic accounting scrutinizes the financial documents that are internal which aren’t readily available to the public; these documents are usually considered in litigation affairs. Generally, the field of accounting was undergoing a major overhaul; before the recent economic crisis that has devastated some parts of the western world, the accounting scandals regarding WorldCom and Enron pushed the field towards change. Accounting in general was put under scrutiny because of increasing white collar crime and the economic crisis pushed that process even faster and further. Ergo, there was an increasing need to have forensic accountants and the field in general needs proper development in its education system and practice for it to be effective.

 “Forensic and investigative accounting is the application of financial skills and investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge, and a sound knowledge and understanding of business reality and the working of the legal system. Its development has been primarily achieved through on-the job training as well as experience with investigating officers and legal counsel. Forensic accountants are also known as fraud investigators, investigative accountants, forensic auditors or fraud auditors.

Hallmark-Sonali Bank Loan Scandal

In May 2012, a report from the Bangladesh Bank revealed that the Ruposhi Bangla Hotel Branch of the state-owned Sonali Bank, Bangladesh’s largest commercial bank, illegally distributed Tk 36.48 billion (US$460 million) in loans between 2010 and 2012. The largest share, of Tk 26.86 billion (US$340 million), went to the now infamous Hallmark Group. And this is the country’s largest banking scandal. It is also known that political parties are also engaged in this financial scandal.

So now it has become essential for Bangladesh to apply forensic accounting. Though forensic accounting seems very costly but only applying this we can investigate the manipulation of financial statement.

Followings are some other importance of Forensic accounting-

* In forensic accounting, the forensic accountant is the bloodhound of Book keeping. External auditors look at the numbers but the forensic auditors look beyond the numbers.
* Forensic accountants are trained to look beyond the numbers and deal with the business realities of situations. Analysis, interpretation, summarization and the presentation of complex financial and business related issues are prominent features of the profession. A forensic accountant will also be familiar with legal concepts and procedures. Public practice or insurance companies, banks, police forces and government agencies are major employers of forensic accountants.
* Forensic account Investigate and analyze financial evidence
* Here all the applications are computerized to assist in the analysis and presentation of financial evidence.
* Forensic accountant communicates their findings in the form of reports, exhibits and collections of documents.
* They also assist in legal proceedings, including testifying in courts, as an expert witness and preparing visual aids to support trial evidence.
* They detect fraud committed by employees: Where the employee indulges in fraud, forensic accountants are engaged. They detect fraud, trace the asset (if any) created out of fund embezzlement, gather and review the evidence, and interview the employee alleged to have embezzled the funds.
* Forensic accountants render arbitration and mediation services for the business community, since they undergo special training in alternative dispute resolution.

Though forensic accounting is now practiced in Bangladesh but the practice of it is very low compared to the developed nations like USA, Canada or Australia. However, to combat the fraud and corruptions inflicting this country’s economy, we need effective tools to measure, detect and prevent the aforesaid nuisances. To effectively implement Forensic Accounting, it can be recommended that references or syllabus of university courses could include this field as it is still unknown for many people.

# Chapter Six: Conclusion & Recommendations

## Conclusion

The concept “creative/cosmetic accounting” assimilates various definitions in the literature. Creative accounting offers an alarming confront to the accounting profession. The problem is an international one, with accounting policy choice being a problem for both developed and developing countries. There is a wide variety of motivations for managers to engage in creative accounting. Accountants who accept the ethical challenge those creative accounting raises need to be aware of the scope for both abuse of accounting policy choice and manipulation of transactions.

## Recommendations

Based upon the evidence before it and the findings made in this report, the following recommendations can be made:

(1) Reinforce Oversight: publicly traded companies directors should undertake steps to:

1. “stop accounting practices and transactions that put the company at high risk of non-compliance with generally accepted accounting principles and results in misleading and inaccurate financial statements”;
2. “prevent conflict of interest arrangements that allow company transactions with a business owned or operated by senior company personnel”;
3. “stop off-the-books activity used to make the company’s financial condition appear better than it is, and require full public disclosure of all assets, liabilities and activities that materially affect the company’s financial condition”;
4. prohibit adequate executive compensation, including by
5. applying ongoing oversight of compensation plans and payments;
6. preventing the issuance of company-financed loans to directors and senior officers of the company; and
7. prohibiting stock-based compensation plans that encourage company personnel to use improper accounting or other improper measures to increase the company stock price for personal gain; and
8. “Prohibit the company’s outside auditor from also providing internal auditing or consulting services to the company and from auditing its own work for the company.”

(2) Strengthening Independence: The Securities and Exchange Commission and the self-regulatory organizations, including the national stock exchanges, should:

1. “Reinforce requirements for director independence at publicly traded companies, including by requiring most the outside directors to be free of material financial ties to the company other than through director compensation”;
2. “Reinforce requirements for Audit Committees at publicly traded companies, including by requiring the Audit Committee Chair to possess financial management or accounting expertise, and by requiring a written Audit Committee charter that obligates the Committee to oversee the company’s financial statements and accounting practices and to hire and fire the outside auditor”; and
3. “Reinforce requirements for auditor independence, including by prohibiting the company’s outside auditor from simultaneously providing the company with internal auditing or consulting services and from auditing its own work for the company”.
4. The management of a company can take the following four actions to reduce the possibility of fraudulent financial reporting:
* “Establish an organizational environment that contributes to the integrity of the financial reporting process.
* Identify and understand the factors that lead to fraudulent financial reporting.
* Assess the risk of fraudulent financial reporting within the company.
* Design and implement internal controls to provide reasonable assurance that fraudulent financial reporting is prevented”

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