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



**United International University**

A Project Report On

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

**Prepared For**

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# Letter of Transmittal

24th December 2018

Mr. Mohammad Amzad Hossain

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**Subject: Submission of Project paper on “Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives”.**

Dear Sir,

I am glad to submit my Project paper on **“Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives”** as a requirement for the completion of the BBA program. I truly believe that this report will satisfy your requirements and expectations as I tried my level best to make this report informative, practical, reliable and relevant as possible.

I earnestly thank you for your guidance during the preparation of this report. If you have any further inquiry concerning any additional information I would be very grateful to clarify that.

I, therefore, request you to accept this report and give me proper suggestion to work in my professional life and I pray and hope that the mistakes of the report may have will be kindly excused.

Sincerely Yours,

……………………………….

Afrin Sultana

ID No: 111 132 189

# Acknowledgment

At first, I would like to convey my deepest gratitude to Allah for giving me the strength and the composure to finish the task within the scheduled time.

I would also like to convey my gratitude from the core of our heart to my mentor **Mr. Mohammad Amzad Hossain,** Assistant Professor of United International University, who helped me in coordinating my entire report. His consistent support and cooperation showed the way towards the successful completion of the report.

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 finds out the cosmetics accounting practices in Developing Countries from Bangladesh Perspective. Cosmetic accounting is a process where accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business.

This report is divided into six chapters. In the introductory part, introduction, purpose statement, and methodology of data collection and limitations of the study are illustrated. The objective of the report is to make an analysis of the cosmetic accounting practices in developing countries.

The second part of the report consists of the literature review that different authors had made research on this topic.

The third part of the report is based on the overview of cosmetic accounting. This part contains definitions, techniques, causes & effects, motivation, managing and ethical perspective of creative accounting.

The fourth part of the report is based on the creative accounting in global perspective which expresses the views of External Auditors, Internal Auditors, and the Accountants on causes, techniques, effects, and solution for Cosmetic Accounting.

Fifth part of the report is based on Enron’s fraudulent financial report analysis. Here also the need for forensic accounting for detection & prevention of cosmetic accounting has been included.

The 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.”*

Cosmetic accounting, which is sometimes called creative accounting that is referred to as income smoothing, earnings smoothing, earning management, cosmetic accounting and financial engineering. The acknowledged term in the USA and the main portion of the literature on the subject is “earnings management”, but the Europeans prefer the term “creative accounting” which will be used in this paper. It should be recognized that some accounting manipulation is involved primarily balance sheet rather than earnings management.

Definitions of creative accounting may vary, including is the cogitate bedewing of fluctuations about “some level of earnings considered being normal for the firm”. (Barnea et al. 1976)

Creative accounting is any management action that poignant reported income which gives no true economic beneficiaries to the organization which may be detrimental in the long run’. (Merchant and Rockness, 1994)

The word cosmetic accounting is largely utilized to describe the acknowledged accounting procedures which allow organizations to report financial outcomes that may not precisely reflect the substance of their activities. Creative accounting techniques are noteworthy as they dwell in use as commonly acknowledged accounting principles, even though they have been shown to be misleading in many cases.

Creative accounting coincides of accounting rehearses which follow necessitated laws as well as regulations, but diverge from what those standards tend to prosecuted. Creative accounting focuses on loopholes in the accounting benchmarks to erroneously reflect a better image of the organization. Although creative accounting rehearses are licit, the loopholes they stunt are often rebuilt to obviate 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 delicacy and solidity of the financial statements are pivotal for the stakeholders of the firms to make felicitous decisions. This fact has become more crucial in present years starting from 2001 by the crumple of Enron and its significance has consolidated with the present financial clutch because of the bankruptcy of largish financial institutions. Even if there remain proper accounting standards (GAAP and IAS) to escort financial accounting agendas, sometimes it becomes undoable to prevent the exploitive behavior of financial statement fixer, who wants to affect the verdict of the financial statement users in the indulgence of their companies. These exploitive behaviors are often called “Earnings Management” and/or “Creative Accounting” “Creative Accounting” is the more acknowledged term in Europe, whereas it more widely to use “earnings management” in the USA

## Origin of the Report

This report has been prepared to conduct 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 Mohammad Amzad Hossain, 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.

## The methodology of the Study

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

## Objectives of 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 survey the stereotypes of cosmetic accounting;
* To describe the causes of cosmetic accounting;
* To describe the methods of cosmetic accounting;
* To describe the effects of cosmetic accounting;
* To describe the motivation for cosmetic accounting;
* To describe how to manage cosmetic accounting;
* To describe the ethical perspective of cosmetic accounting;
* To describe cosmetic accounting from a 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 a large study where lots of 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 notion of creative accounting is generally used to limn the operation through which the accounting professionals use their knowledge to exploit the figures mentioned in the annual accounts. Accounting has been described 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.).

Creative accounting was maiden used in 1968 in a Mel Brooks’ film. According to Wikipedia, it is accounting rehearses which diverge from acknowledged accounting run-overs. These exercises are depicted by excessive compendium and the use of strange ways of representing income, liabilities or assets. This results in financial reports that are not all obtuse, but have all the intricacy of a novel, so as the name “creative”. Creative accounting is the reason of some recent accounting disgraces, and many proffers for accounting redeem that centered on an upgraded dissection of capital and factors of output that would correctly portray how value is merged (Osisioma and Enahoro, 2006).

Karim, Fowzia, & Rashid (2011) anatomized that Cosmetic accounting is a procedure where accountants use their knowings of accounting systems to diverge the figures mentioned in the accounts of a business. In their study, they specified the perspectives of Internal Auditors, External Auditors, and the Accountants on techniques, causes, effects and solution for Cosmetic Accounting.

Fagbemi & Olaoye (2014) did a study on the perscrutation of the global situation over the past ten years has transpired many cases of corporate defeat, simplified by devious exploitation of accounts by management and with the tenor of accountants in some situations. This exploitation is often alluded to as cosmetic accounting. These cases have enforced the examination of the outcomes of these fake practices. The study brought out primary data from accountants in Nigeria. Outcomes from the study describe that defenders are sensible of cosmetic accounting and that it is not ethical. The outcomes also show that the stakeholders suffer as an outcome of decisions taken using a manipulated financial statement. Proof also exist that managers and auditors of corporate firms have a character to play in confirm huge business and ethical standards to pilot against cosmetic accounting.

Diana & Mdlina (2008) resolved the exploitation of financial facts which is called by many terms such as income smoothing, earnings management, aggressive accounting, creative accounting practices or account manipulation, blocks the fission of resources in the most effective areas in the economy. The extent of this paper is to utter the causes, the main dictation behind their application, the objectives, the procedures and the results of exploitation in financial reporting. Creative accounting is not a recent technique, but it can be seen as an expensive one. Businesses see the pressure to show themselves profitable to attract new resources and investors, but defective or fake accounting practices often lead to devastating outcomes.

B. (2014) perused the outcome of creative accounting on the Nigerian banking industry with the intention of finding out the reason behind the practice of creative accounting in the Nigerian banking industry, to make sure whether creative accounting has participated to banks’ devastation in Nigeria, and to peruse plans that could reduce the practice in the Nigerian banking industry. The main source of data gather was mentioned in this study and statistical tools utilized to examine the data were the multiple bar chart analysis and the Kruskal-Wallis test. The outcome of this study elicited that the main reason for creative accounting practices in the Nigerian banking industry was to distend the operation costs to abate manifestation to taxes. It was also found that other reasons for creative accounting practice in the Nigerian banking industry include: to help keep or enlarge the share price by abating the discernible levels of borrowing, making the organization appear subject to minimized risk and of a better profit trend, to distend the number of operating costs to minimize disclosure to taxes, to show a firm trend of accrual in profit, rather than mildly unstable profits with a series of rises and falls, and to upshot effect changes in accounting precedences in order to disarm findings problems in the company’s accounting system. It was seen that that creative accounting has an important influence on banks dole in Nigeria and it was also seen that meaningful techniques can reduce the practice of creative accounting in the Nigerian banking industry.

Chapter Three: Overview of Creative Accounting

## The concept of Cosmetic Accounting

Creative Accounting relates to the application of accounting wisdom to impress the reported figures, while remaining within the authority of accounting rules and laws so that rather of showing the actual performance or berth of the organization, they imagine what the manager wants to tell the investors. The leaned term in the USA, and thus on the top of the literature on the subject is ‘earnings management’, but in European countries, the leaned term is ‘creative accounting’. It should be avowed that some accounting exploitation is involved initially 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) complies that ‘disclosure management’ can be compared with ‘creative accounting’, in the feel of a purposeful mediation in the financial reporting procedure.

Many stints can be used to render the rehearses of changing the materialities in accounting, e.g. cooking the books, massaging the numbers, aggressive accounting, earnings management, window dressing, etc.

|  |  |
| --- | --- |
| **Label** | **Definition** |
| Aggressive Accounting | When an intentional falsification is done to get desired results, normally high earnings, also the followed procedures are not acknowledged by GAAP  |
| Earnings management | Earnings are manipulated to reach a specific target which is set by the management to reveal a sustainable stream of earning to the stakeholders |
| Income Smoothing | Designing earning management to remove valleys and peaks from earning series and store profits to supplement the slower years |
| Fraudulent financial reporting | False records in financial statements to deceive stakeholders so that they can not get a view of the company’s poor financial performance and also fooled by the administration |
| Creative accounting practices | Taunting with numbers and digits to give a positive view to the shareholders and auditors and falsify the financial statements, records, and earnings |
| *Source: The Financial Number Game by Charles W. Mulford& Eugene E. Comiskey, 2002 (John Wiley & Sons)* |

## Strategy of Creative Accounting

In this nabe tacks used for creative accounting and/or earnings management will be described based on different investigations in the study.

* **Recognizing Premature or Fictitious Revenue:** Recognizing forward revenue and feigned revenue differ in the degree to which incursive accounting objects are taken. In the case of forwarding revenue, revenue is avowed for a licit sale in a period prior to that called for by ordinarily accepted accounting morals. On the other hand, fictional revenue recognition subsumes the recording of revenue for an absence of existence sale. It is often stiff, however, to task a label to such revenue recognition rehearsals because of the husky gray area that subsists between what is fictitious and what is premature revenue recognition.

Examples:

- Revenue recognized for products that have been stated but that have not been shipped at the time of recognition would be calculated by most to be premature.

- Recording bill-and-hold sales deals or other omens that sales are recognized in advance of pilotage.

- Recognizing tentative sales depending on the emergence of financing, resale to third parties, final adoption, performance guarantees, and further customer shuffles.

- Overstating percentage-of-completion revenues when there is dubiousness about the bona fides of the baseline contract.

- Unreasonably 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 that 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 went 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 the determination of the portion fan expenditure to capitalize is straightforward in many cases, items as direct-response advertising and software development costs require perception 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 in inventory manipulation by either manipulating the amount of the inventory or by valuing it. In years when profits need to be raised the quantity can be manipulated by doing a particularly rigorous stock-take. Provisions for absolute and slow-moving inventory and changing the effective method of inventory valuation are the practices of manipulating inventory values.
* **Abuse of Materiality Concept:** It entails misapplying the concept of actuality by willfully recording lapses within an explained percentage line. Firms gratifying in this rehearse try to detect a gloss for it by claiming that the result on the net income is too little to signify.
* **Being Generous with Bad Debts:** Organizations, which are bottom on credit sales, make stipulations for bad and doubtful debts bottom upon their doom. Ergo, when they want to increment their avails, managers can prognosis that there will be a very small level of non- payment.
* **Getting Creative with the Income Statement:** It comprises the drill of intimating a diverse level of earning power conducting the setup of the income statement rather than midst the etiquette in which deals are listed. For example, companies may report an on reciting boost as ‘a reciting expense mightier abele as nonrecurring’, ‘reciting revenue caption’, or ‘other revenue’. This will end in larger discernible levels of reciting earnings except converting total net income.
* **Problems with Cash-flow Reporting:** Different way for organizations to convey a larger earning force is reporting larger and more tenable cash flow. A company’ presumed tearing force will be greater with the implicit reciting caliber of functioning cash flow. Thus, a sturdy can place an operating expenditure as a financing or engulfing item, or financing inflow or conferring might be sorted as an operative item. In fact, if this step will not vary the total revise in cash, they will amplify the cash flow from assignments.

## Causes of Cosmetic (Creative) Accounting

The honest spawns of creative accounting lie in the disputes of stake among separate stake groups. Managing investors’ share is to pay small tax and dividends. Shareholders-investors are keen to pick up more dividends and capital gains. Country’s tax artists would like to save more and more taxes. Employees are attentive to get a good salary and larger profit share. But creative accounting puts one clot or two to the advantageous situation at the charge of others. Earnings per share (EPS), the only number to which shareholders often go immorality by paying too much absorption, 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) receivables or inventories growing faster than sales, (ii) negative cash flow, (iii) hidden pension liabilities, (iv) capitalizing expenses instead of writing them off, (v) following seemingly conservative practice in a situation of reverse, and (vi) consolidating owned

Subsidiary’s income and net worth, with the impossibility of receiving the same.

## Effects of Cosmetic Accounting

The obvious effects of creative accounting are as follows:

1. There are organizations cataloged on the stock exchange, which stout inflated benefit and better financial post in their cosmetic accounting statements to attract shareholders; this creation of accounts just humbugs and invents maze.
2. Some organization catalogs may not every time portray the fact of the financial posts of the categorized organizations and firms.
3. Steps taken for induced cosmetic accounting invoices may clutch out fake trusts to shareholders for a smaller time but cannot persist to succeed for a larger time.
4. Ultimately, the worried organizations categorized in the share exchange implode and the shareholders mislay trust in them and the gray market.

## The motivation for Cosmetic Accounting

Cosmetic Accounting helps in the 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 the least amount of taxes. Board of Directors wishes to pay a 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 an advantage, naturally at the cost of the others. David Schiff (1993-94) has warned the investors that reacting an 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 the 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 the 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. The 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 an 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 intracompany transactions. | Variation in inventory valuation methods. | Adjusting revenue recognition 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 company has the power to represent itself sightly, so no danger in topping up the financial numbers. If this is not right then presumably no beauty item producer should take film artists in their advertisement drives, no energy drink should be plumped by sportspersons, no pharmacy items are legitimatized by doctors and so on. But as far as creative accounting is interested, all should be work under the umbrella of a swaying body that can terminate the diversity between ingenuity and scam. Surveillance committee or tribunals who have the 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 a 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 a 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 zones 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 hyperactive 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 the 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 the 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 the 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.

##

# Chapter Four: 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

### Improper Recognition of Revenue:

Most of the transactions among Chewco, JEDI, and Enron was not seem to found having an economic spirit and found having been gone into with the only preference of speeding Enron’d recognition of profit. A short description of a few of these transactions are given 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, it was sectionalized as a constructing fee worth $17.4 million, $10 million of this amount was identified at once (in 1997), left was identified in early 1998. At first, it was not clear why JEDI intentionally clear Chewco’s liability. Secondly, it also did not take into calculation any of the transaction of danger dynamics. At last, Enron identified these transactions as “constructing fees” and showed these into income instead of amortizing these payments over the deadline of the guarantee.
2. As per contract, JEDI had to pay Enron an annual fee which greater of 2.5% of $383 million or $2 million. The fee was paid through 2003. In 1998, Enron reconstructed the contract & recognized these fees as a “required payment” to Enron. Enron identified the payment of $25.7 million at once as profit in March 1998. This was improper due to these following reasons: the payments were done due to the services that were to be given by Enron to JEDI over 1998-2003 which did not seem correct to classify the fees before even the services were given.
3. JEDI clenched 12 million shares of Enron stock and reported all its assets under the fair value method. Therefore, any increase in value was taken as unrealistic gains into its income statement. During the Enron stock’s appreciating period, JEDI identified eloquent gains. Enron, which reported JEDI considering the equity method, took an increase on the appreciation of its own stock! While the precise amount is blurry, it looked like $126 million was received in one quarter during 2000. What is overwhelming was when the stock lost value in 2001, Enron did not identify its share of loss that was nearly $90 million.

### Undervaluation of liabilities

The main purpose of Chewco was to keep debt vanished from the balance sheet of Enron. Chewco (which was a limited partnership and was formed in 1997) was the very first time that Enron utilized an SPE that was run by an employee from Enron to keep transactions invisible from the financial statements of Enron. The partnership redirected to involve a worth $500 million joint venture between the CALPERS (California Public Employees’ Retirement System) and Enron during 1993-96 called the “JEDI”. Enron expected CALPERS to take part actively in a new JEDI II partnership, Enron was in need to buy-out CALPERS and find a new limited partner. Enron constructed a connection financing arrangement under which Chewco might be able to raise $383 million (to pay CALPERS) in an expected manner: (1) a $250 million loan to Chewco from a bank finalised by Enron (2) a $132 million credit arrangement between Chewco and LJM and (3) equity generation of $11 million by Chewco as though the source of this was blurry. Regardless of the fact of no equity but debt, Enron decided not to polarize the transaction in its accounts. Thus, Enron kept debt off from Enron’s balance sheet.

### Hedging Activities

Enron pierced into about not less than 20 hedges with the Raptors having a metaphysical value of $1.5 billion November 2000. So, Enron counterpoised losses in its investments of $500 million by analogous gains on the hedges. Following are two (02) examples:

1. **Talon and Avici**: Talon was utilized to hedge Enron’s investment in Avici Systems Inc. (Avici), and it was an Internet architecture firm. Enron occupied a huge share of the company’s stock and later, it pierced into a total return shift with Talon on Avici stock. At that time Avici dickered for about $95.50 per share. Later, Avici stock quid pro quo for $162.50 per share, it’s all time maximized. After a while, when Avici had decreased to $95 a share, Enron equipoised $75 million in losses due to the shift.
2. **Porcupine and TNCP**: Porcupine and Enron pierced into a total return shift on $18 million shares of TNCP stock at $21 per share. This gave Enron to lock in an increase on its transactions with Hawaii 125-0 at an amount of $370 million.

### Marked-to-Market Accounting:

By the fall of 2000, Enron started to ebb under its own weight. CEO Jeffrey Skilling found a strategy of hiding the financial losses of the trading business and other operations of the firm; it was designated mark-to-market accounting. This was utilized in the trading of securities when you decide what the main cost of the security is at the moment. This could work out well for securities, but it can be dangerous for other businesses. Some of the illustrations of Enron’s mark-to-market accounting transactions have been given below:

1. Less demand for movie rental business through Enron broadband business direct to the end of the developmental project partnership between Enron & Blockbuster. Enron wanted to monetize the mislay & got into a second partnership with CIBC World Markets. CIBC paid $115.2 million & Enron identified $110.9 million as profit for the last quarter of 2000 and the first quarter of 2001. This whetted decreased the losses Enron had to identify from the fiber-optics division.
2. Enron invested near $10 million in the company and over a year beginning March 1998, Enron’s investment value reached a peak of $300 million. Though management’s competency to sell the stock was coerced by a lock-up accord, it was jolting that Enron accounted for the stock as part of its business portfolio and took the unidentified increase into its income statement maintaining a mark-to-market on the investment.

###  Non-disclosure of material information

1. From 1993 through 1996**,** Enron and the "CalPERS' (California Public Employees**'** Retirement System) were partners in a $500 million franchise investment partnership called "JEDI' (Joint Energy Development Investment Limited Partnership). Because Enron and CalPERS had control of the partnership**,** Enron did not polarize JEDI into its polarized financial statements. The financial statement effect of non-polarization was important: Enron would expect its contractual part of increase and losses from JEDI on its income statement and would divulge the gain or loss under in its financial statement footnotes, but would notshow JEDI's liability on its balance sheet.
2. Both the LJM1 example and the LJM2 case increased purport corporate governance issues. Unlike Kopper, Fastow was a more senior employee of Enron and the altercation that can be put forth is that if he curbed LJM1 and LJM2, it could be conjectured that Enron tamed 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.

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

Regardless of the term accounting in forensic accounting, the discipline is not related to only reading financial statements which are available to the general public or dealing with other accounting problems; the conventional accountants’, portfolio managers, investment analysts, etc. already do the conventional financial tasks. Instead, forensic accounting scrutinizes the financial papers that are internal which aren’t readily reachable to the public; these documents are normally considered in litigation affairs. Generally, the field of accounting was undergoing a crucial overhaul; before the recent economic hazard that has destroyed some parts of the western world, the accounting scandals regarding WorldCom and Enron pushed the field to change. Accounting in whole was put under scrutiny because of increasing white-collar crime and the economic devastation pushed that process even faster and further. Ergo, there was an increasing necessity to have forensic accountants and the field in general needs proper progress 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 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.” (Cram, November 2017)

As in Bangladesh where the less ethical facets of creative accounting are unhindered, the knowledge of forensic accounting needs to be introduced and recognized. Forensic accounting’s “Financial Statement Alert” scans public companies’ debatable accounting practices, adjures investors to catechize delicately shareholder letters and management’s confab and analysis of financials, and to stretch to read between the lines.

Hallmark-Sonali Bank Loan Scandal

In the month of May 2012, a report from the Bangladesh Bank disclosed that the state-owned Sonali Bank’s Ruposhi Bangla Hotel Branch of, Bangladesh’s biggest commercial bank, unethically assorted Tk 36.48 billion (US$460 million) as loans from 2010 to 2012. The biggest share, of Tk 26.86 billion (US$340 million), was given to the now renowned Hallmark Group. And this is the biggest banking scandal. It is also ostensive that political parties are also merged into this financial scandal.

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

Followings are some other importance of Forensic accounting-

* In forensic accounting, the forensic accountant is the bloodhound of Bookkeeping. External auditors look at the numbers but the forensic auditors look beyond the numbers.
* Forensic accountants are conditioned to look beyond the digits and deal with the business realities of situations. Interpretation, analysis, summarization and the presentation of baroque financial and business related issues are bodacious features of the profession. A forensic accountant will know the legal concepts and techniques. Public practice or banks, insurance companies, government agencies, and police forces are major employers of forensic accountants.
* Forensic account analyze and investigate financial evidence
* Here all the applications are computerized to ease in the anatomizing and presentation of financial testament.
* Forensic accountant transfuses their judgment in the form of exhibits, reports, and collections of documents.
* They also take part in legal procedures, like testifying in courts, as an expert witness and constructing visual aids to support trial testament.
* 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 the practice of it is very less compared to the evolved nations like USA, Australia or Canada. However, to fight the corruptions and fraud inflicting this country’s economy, we need useful tools to calculate, prevent and detect the forenamed gadfly. To fruitfully utilize Forensic Accounting, it can be considered that syllabus or references for university courses could encompass this field as it is still not known for many people.

# Chapter Five: Conclusion & Recommendations

## Conclusion

The concept “creative/cosmetic accounting” compares various portrayal in the literature. Creative accounting gives a dread defy to the accounting profession. The disturbance is an international one, with choice of accounting policy being a problem for both developed and developing countries. There is a vast multiplicity of boosts for archons to occupy in creative accounting. Accountants who take the ethical challenge that creative accounting comes up need to beware of the chance for both ill use of accounting discretion choice and exploitation of transactions.

## Recommendations

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

(1) Hardening Oversight: Directors of companies which are should take hoofs to:

1. ban accounting rehearses and transactions that put the organization at the maximum threat of non-compliance with usually considered accounting principles resulting in false leading and erroneous financial statements;
2. ban dissent of interest arrangements that benefit company transactions with a business operated or owned by senior company professionals;
3. ban off-the-books exertion used to make the company’s financial situation seem better than it is, and practice full public divulgence of all liabilities, assets, and activities that actually affect the company’s financial situation;
4. prevent excess executive compensation, including:
5. practicing running guidance of compensation payments and plans;
6. prohibiting the allotment of company-financed loans to directors and senior officers of the organizations; and
7. prohibiting stock-based compensation procedures archly amplify company personnel to use unethical accounting or other improper tactics to maximize the company stock price for personal benefit; and
8. Prevent the company’s 3rd party auditor from also giving internal consulting or plans services to the organizations and from auditing its own activity for the company.

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

1. Fortify requirements for director self-reliance at publicly traded companies, including by claiming most the shell directors to be disenthrall of material financial connection to the company other than through director compensation;
2. Harden essentials for Audit firms at publicly traded companies entail by claiming the Audit Committee Chair to retain financial management or accounting expertise, and by holding a written Audit Committee charter that coerces the Committee to regulate the company’s financial statements and accounting rehearses and to hire and fire the outside auditor; and
3. Strengthen essentials for auditor independence, including by interdict the company’s outside auditor from coextensive providing the company with internal auditing or discussion services and from auditing its own work for the company.
4. The management of a company can take the following actions to decrease the possibility of fake financial reporting:
* Substantiate an organizational medium that chip into the decency of the financial reporting procedure.
* Find out and understand the delegates that lead to fraudulent financial reporting.
* Impose the risk of deceitful financial reporting within the company.
* Design and implement internal regulations to provide coherent certitude that fraudulent financial reporting is prohibited.

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