Worldcom creative accounting flashcard

Creative accounting refers to accounting practices that seem to follow the letter of the applicable accounting standards but deviate from the spirit of those standards. It is the use of accounting methods to hide aspects of a company’s financial dealings in order to make the company appear more or less successful than it is in reality. In other words, Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them.

The motivation to indulge in these practices is anticipation of rewards which may include higher share prices, improved credit rating resulting in lower borrowing costs, higher incentive compensation for executive management etc. Some of the creative accounting schemes perpetrated by companies include improper revenue and expense recognition, faulty accounting in connection with business combinations, and wrongful use of off- balance-sheet arrangements. . Listed companies engage in creative accounting practices include the usual smooth earnings, balance-sheet financing, abuse of mergers and acquisitions accounting, any changes to accrual method of manipulating the consolidated financial statements, asset replacement and so on.

These fraudulent schemes can be devastating to users like shareholders, lenders, employees, board of directors and other stakeholders. The conflicts of interest among different interest groups represent the real causes of creative accounting. The managers are interested in paying fewer taxes and dividends, the shareholders in gaining higher dividends, the employees in obtaining better salary and higher profit share, the authorities in collecting more taxes. It can be easily seen that the interests are tremendous divergent and creative accounting is deepening it. But creative accounting puts one group or two to advantageous position at the expense of others. Sometimes for investors taking a company’s financial statements at Face value can be ‘ a recipe for disaster’.

Reasons for creative accounting

1) Income smoothing. Companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. This is achieved by making unnecessarily high provisions for liabilities and against asset values in good years so that these provisions can be reduced, thereby improving reported profits, in bad years. It is argued that it is a measure against the ‘ short-termism’ of judging an investment on the basis of the yields achieved in the immediate following years. It also avoids raising expectations so high in good years that the company is unable to deliver. But, if the trading conditions of a business are in fact volatile then investors have a right to know this and it may conceal long-term changes in the profit trend.

2) A variant on income smoothing is to manipulate profit to tie in to forecasts. This perfectly respectable, and highly conservative, accounting policy means that future earnings are easy to predict. E. g. Accounting policies at Microsoft are designed, within the normal accounting rules, to match reported earnings to profit forecasts. When Microsoft sell software a large part of the profit is deferred to future years to cover potential upgrade

and customer support costs. It allows them to match reported earnings to profit forecasts.

3) Company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news. E. g. A change in accounting method boosted K-Mart's quarterly profit figure by some $160 million, by a happy coincidence distracting attention from the company slipping back from being the largest retailer in the USA to the number two slot.

4) Creative accounting may help maintain or boost the share price both by reducing the apparent levels of borrowing, so making the company appear subject to less risk, and by creating the appearance of a good profit trend. This helps the company to raise capital from new share issues, offer their own shares in takeover bids, and resist takeover by other companies.

5) If the directors engage in ' insider dealing' in their company's shares they can use creative accounting to delay the release of information for the market, thereby enhancing their opportunity to benefit from inside knowledge.

Scope of creative accounting

1) Flexibility in regulation. Generally the regulation, particularly the accounting regulation permits flexibility in choosing a policy to follow; the International Accounting Standards let the financial management to choose between valuation of the non-current assets at depreciated historical value

or at revaluated value. The management may decide the change of the policies, and these shifts are difficult to be identified a few years later.

2) Certain entries in the accounts involve an unavoidable degree of estimation, judgment, and prediction. In some cases, such as the estimation of an asset's useful life made in order to calculate depreciation, these estimates are normally made inside the business and the creative accountant has the opportunity to decide on the side of caution or optimism in making the estimate. Management can use their discretionary position in order to obtain the financial position and stability they assumed; for example, the managers decide the increase or reduce of the provisions for bad debts.

3) The timing of some transactions offers to the management the opportunity to increase the revenues, when the operating profit is not satisfactory, and to create the desired impression in the accounts. The existing stocks in company's patrimony, that have a significant higher value compared to the historical value, may be sold only when the operating profit is not satisfactory.

4) Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a ' sale and leaseback' can be pitched

above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

5) Reclassification and presentation of financials are relatively less analyzed in accounting literature. However, in reality the companies often proceed to make up the amounts in order to obtain good level of profitability, liquidity or leverage ratios. Most of the times, the numbers are smoothly modified in order to improve the investors' perception. ' the idea behind this behavior is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million'. Some minor massaging of figures does take place in order to reach significant reference points.

6) Companies may increase their earnings by hiding the pension Liabilities, by capitalizing the expenses instead of writing them off, by realizing a faster increase of The receivables or inventories versus sales, by reaching negative cash flow, by consolidating the Affiliates' incomes and net worth, and) by following seemingly conservative practice in a situation of Reverse direction.

Accounting regulators who wish to curb creative accounting have to tackle each of these approaches in a different way: 1) Scope for choice of accounting methods can be reduced by reducing the number of permitted accounting methods or by specifying circumstances in which each method should be used. Requiring consistency of use of methods also helps here, since a company choosing a method which produces the desired picture in one year will then be forced to use the same method in future circumstances where the result may be less favorable.

2) Abuse of judgment can be curbed in two ways. One is to draft rules that minimize the use of judgment. In the UK Company accountants tended to use the ‘ extraordinary item’ part of the profit and loss account for items they wished to avoid including in operating profit. The UK Accounting Standards Board (ASH) responded by effectively abolishing the category of ‘ extraordinary item’. Auditors also have a part to play in identifying dishonest estimates. The other is to prescribe ‘ consistency’ so that if a company chooses an accounting policy that suits it in one year it must continue to apply it in subsequent years when it may not suit so well.

3) Artificial transactions can be tackled by invoking the concept of ‘ substance over form’, whereby the economic substance rather than the legal form of transactions determines their accounting substance. Thus linked transactions would be accounted for as one whole.

4) The timing of genuine transactions is clearly a matter for the discretion of management. However, the scope to use this can be limited by requiring regular revaluations of items in the accounts so that gains or losses on value changes are identified in the accounts each year as they occur, rather than only appearing in total in the year that a disposal occurs. Effects of creative accounting

1) It creates confusion among the stock exchange investors, because the figures shown by financial statements are often inflated and the difficult to distinguish between the fair and unfair statements. 2) The prospectuses of the listed companies do not always offer a detailed picture the financial positions and performance. 3)The techniques used by creative accounting

can “ impress the investors only over short time periods, while the financial position goes worse, this cannot be hidden anymore and these methods are helpless. 4) The long time effect of such practice is the distrust of the investors conducted by the collapse of companies that take advantage of these techniques.