Manipulation strategies in accounting

IAASA

Irish Auditing and Accounting Supervisory Authority was established in 2006 for providing Ireland with strong regulatory environment and exercise its powers under the provision of companies act 2014.

Roles and Objectives (IAASA)-

- To help with the betterment of the working of financial reporting and enhances the quality of auditing of public interest entities.
- Issuing the auditing reforms for the entities and providing any guidance on these standards.
- Examination and enforcement of selected listed companies for the periodic financial reporting.(*IAASA – Our Role* , 2006, pp. 1)

Functions –

- To undertake investigations for the breach of the standards of an accounting body.
- To corporate with other accounting bodies to create/provide accounting standard to other auditor and supervising the effectiveness of those standards.
- To approve and register of statutory auditors.
- To approve and evolve their regulatory plans.
- To sanction approval under Section 933 on prescribed accounting firms.(*IAASA – Functions* , 2006, pp. 1)

Limitation of International Accounting Regulations –

In this paper, we will be looking at more insidious or may be more destructive practice of manipulating not only the number but the operating decisions that affect those numbers in these financial reports. Following are the analysis of each of this problem –

Universal Standards-

By 2005, all public companies of European Union disbanded their local accounting standard in favour of IFRS. The way the IFRS regulations applied varies from one country to another. Each carries its own set of regulation and compliances as many countries made his or her own versions of IFRS regulation by imposing “ carve ins “(addition of passages) and “ carve-outs” (removal of offensive passages) such examples are India and China. (Sherman and Young, 2016, pp. 2)

Revenue Recognition-

The inadequacy of revenue recognition practices has caused companies to increase the use of unofficial measure to report the financial performance. A change in rules under IFRS should elevate the perversities of current revenue recognition practices, the new rules will allow companies to recognize the revenue in the year it is earned. But the change will not completely eliminate the problem. (Sherman and Young, 2016, pp. 2)

Unofficial Earning Measures-

Although unofficial measures of revenue are relatively new for many companies, almost all types of businesses have been practicing no IFRS measures of earning for a long time. Perhaps EBITDA is favoured by investors because it provides a quick proxy for the amount of cash flow available to service debt. An analyst should continue the interpretation related to unofficial earing with great caution. (Sherman and Young, 2016, pp. 5)

Fair value Accounting-

Executives have two measures to determine the value of a firm's assets the price originally paid and the fair value. Today, however, companies use fair value in the hope that the balance sheet will yield a truer picture of current economic reality. There are some situations where fair value can't be applied such as goodwill, patent, earn-out agreements. (Sherman and Young, 2016, pp. 7)

Brief Synopsis of Failure of International Accounting Standards-

WORLDCOM ACCOUNTING SCANDAL

WorldCom has reviled $3. 3 bn in accounting errors, doubling the size of the accounting scandal at America's second largest telecommunication company to more than $ 7 bn.

According to WorldCom, an internal auditing discovered $3. 3 bn in profits were wrongly recorded in the books from 1999 to the first quarter of 2002. The revision reduces the year 2000 profits by more than $3. 2 bn, but this may not be the end of accounting fraud as it may find more problem.

WorldCom said most of $3. 3 bn was involved in manipulation of the reserves. Keeping reserves aside is a legitimate practice but, reserves can be abused to create the accounting equivalent of the slush fund. The suspicious is that WorldCom deliberately inflated its reserves to be able to dip into them to boost profits in order to meet the profit projection of the company.

WorldCom chief executive John Sidgmore blamed the companies former financial officer Scott Sullivan and the former controller David Myers, these two were fired for claiming $3. 8bn in regular expenses as the capital investment in 2001. WorldCom founder Bernie Ebbers said that he was unaware of the accounting problems that the companies were facing.

WorldCom said it may have to write off $50 bn when it restates its finances. (Tran, 2002)

New accounting standards 2018

IFRS 15 Revenue from contract with customers

Issued by the Board on May 2014 and came into effect from January 2018. IFRS 15 replaces IAS 18 and IAS 11. This establishes a comprehensive framework for defining when to recognise revenue and how much revenue will be recognised. It will further help to increase comparability among companies across sectors and markets and it will affect almost all the companies because it covers revenue from all contracts with clients (except leases).(International Accounting Standards Board, May 2014, pp. 4)

Correct requirements –

Identifying contracts with customers also to look for performance obligation in the contracts. Determine the transaction prices and allocate it to each performance obligation on the basis of selling price of each product. Also recognise the revenue when a performance obligation is satisfied by transferring of good or services.(*IFRS – IFRS 15 Revenue from Contracts with Customers* , no date)

Manipulation –

Fraudulent revenue recognition cases are dominant. Revenue is an influential number in a financial statement so if the revenue from customers contracts are recorded deliberately incorrect then it will manipulate some of the vital ratio of the company such as profitably, liquidity and solvency. (Almoshashi, 2017)

IAS 38 Intangible Assets

IAS 38 was revised in march 2004 and came into effect on to intangible assets on 31 March 2004. It outlines the accounting requirements for intangible assets which are those assets that are not physical in nature(Either being separable or Arising from legal contracts) such as goodwill, Patents, licences, trademarks.(Deloitte Global Services, 2017).

The objective of IAS 38 is to show the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. (*IAS 38 Intangible Assets* , 2010).

Correct requirements –

Intangible assets are recorded at cost if only bought from another entity. Cost includes all the expenditures to make that intangible asset ready for use. If the recording should be done for a stock or in exchange of other assets then the cost will be the fair value taken in consideration or the fair value received.(*Reporting and Analysing Intangibles | Boundless Accounting* , no date)

Manipulation –

Goodwill is an important factor determining true profitability. The recent goodwill write offs create a false impression about the possibility of expected profits materializing and justifying the assets labelled goodwill on the balance sheet.

Alternative Performance Measures (APM)

It is a financial measure of historical or future financial performance or cash flows, other than a financial measure defined in financial reporting framework. APM's are typically based on financial statements which have the applicable financial reporting framework, adjusting amounts from the figures mentioned in financial statements. E. g.- operating earnings, cash earnings, EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).

Issuers or persons responsible for the prospectus should explain why APM provides useful information about financial position, cash flows as well as the specific use of APM. APM's should not be displayed with more authority measures directly stemming from financial statements. (' European Securities and Market Authority', 2015, pp. 6, 7).

Correct Requirements –

APMs should be meaningfully labelled and defined as “ headline earnings” in the footnotes of the financial statements. Purpose of APM should be properly set out presenting why the management believes it is useful information. Clear reconciliation of APM should be presented in a form of practical perspective to present this reconciliation in the appendix of annual report.

(‘ july-27-2016. pdf’, 2016, pp. 8)

Manipulation –

Accounting for Receivables Purchase Agreements (RPA’s)

It is an agreement between a buyer and a seller in which seller sells the receivables to get liquidity up front and the buyer has all the rights to collect the receivables from original customers. RPA’s gives the company chance to sell off as yet unpaid bills. Buyers get a profit-making opportunity while seller gains the security. This type of agreement forms a contractual framework.

These agreements are mostly between multiple parties which works as follows – One company sells its receivables; another party buys the same and the additional companies serve as administrators or servicers.

Correct Requirements-

First point to consider is that how long seller takes to collect the receivables, if the seller took long then the buyer will demand more discount.

Receivables have certain allocation percentage which means if they are less than 30 days may put out a 90% and those which are between 30 to 60 days may put around 75%.

If there is any type of tax saving’s, then the seller has the rights to exclude this tax savings.

MANIPULATION EXAMPLES-

Intangible assets (IAS 38)

Considering the case of Nokia Corporation which is about the risk of reflecting intangible assets into financial statements by measuring their values. Nokia’s total assets are 11 billion USD, liabilities are 5. 3 billion USD and residual cost are 5. 7 billion USD. The difference between market value and book value of the company is 183 billion USD and this difference is due to intangible assets. After one-year market value of Nokia dropped to 97 billion USD. The depreciation on intangible assets can be a cause to lose money of the company (86 billion USD). Taking intangible assets into financial statements to present company’s better financial position particularly in the case of exaggerated measurement and evaluation which can mislead the investors who wants to invest in the company. (Yardimcioglu and Karasioglu, 2008, p. 5)

Revenue from Contracts with Customer (IFRS 15)

The most obvious frauds take place due to creation of fake revenues and related documentation to make revenues look better. McKesson and Robbins is the example of such fraud. This company was taken over by Philip Musica.

Musica had a rather doubtful past with a lot of criminal acts using fake names to increase the members to help the company grow. Musica started creating fake purchase orders, inflate inventory numbers and scheme cash from the company sales to improve the revenues. When this fraud was finally discovered the company had 10 million USD in non-existent stock on the financial statements with 9 million USD in fictitious receivables. (Pleasant, 2018)

Reasoned Conclusion–

As seen in the earlier part of this paper we saw the limitation of the International Accounting standards that clearly suggested that regulatory framework for international accounting is very much flawed . As there are still many countries that doesn’t uses these accounting standards and most of which does make its own improvement to facilitate themselves, which doesn’t coincide with the other countries that are following the standard to the core, for example United States of America still doesn’t uses the International Accounting standard although they have started taking approach towards these standards but no one know how long before they actually will start using them. Where as there are loads of companies using fair value for evaluating their firms which still big parts such as patents, licences out of the question of being audited.

In contradiction to the above statement International Accounting standards has already been recognised as the best and common ways to audit an entity through out the world which leads the MNCs to start using these standards which influences a sector to use these standards. As these accounting standards are ever evolving to nature the business keeping all the loophole and alternatives in the mind, which sure will not only make these standards mostly effective.

Although these standards are made by the accountants for the accountants as the new standards or the alteration of new standards come into enforcement, for which there is already a loophole create. So, in our regards no one can clearly state when or how these accounting standards will be fully efficient. But the steps in the right direction are already taken by IASB.

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