FINANCIAL TIMES

Uncovering Creative Accounting

KEVIN AMOR AND ALAN WARNER

Executive Briefings

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An imprint of Pearson Education

London • New York • Toronto • Sydney • Tokyo • Singapore
Hong Kong • Cape Town • Madrid • Paris • Amsterdam • Munich • Milan

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Website: www.briefingzone.com

First published in Great Britain in 2003

ISBN 0 273 66361 5

British Library Cataloguing in Publication Data
A CIP catalogue record for this book can be obtained from the British Library.

10 9 8 7 6 5 4 3 2 1

Typeset by Monolith – www.monolith.uk.com
Printed and bound in Great Britain by Ashford Colour Press Ltd, Gosport, Hants.

The Publishers' policy is to use paper manufactured from sustainable forests.

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MTP was formed in 1987 as the Management Training Partnership and has grown rapidly to become one of the largest UK providers of tailored management training. MTP designs and delivers tailored programmes in three core areas: finance, marketing/strategy and leadership. It has a range of blue-chip clients including Boots, BP, GSK, ICI, Pearson, Shell and Unilever.

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Contents

Executive summary

This book sets out to provide an overview of the judgement areas involved in accounting, and the ways in which the results can be manipulated by managers and accountants who desire a particular outcome.

It starts in Chapter 1 with an overview of accounting principles and concepts, including the purpose of accounting statements and the way in which the profit and loss account and balance sheet are linked together by accounting processes. Chapter 2 covers the responsibilities of the various parties for 'true and fair' accounting and includes the roles and responsibilities of directors, auditors and the accounting bodies.

The next three chapters provide a comprehensive overview of the ways in which profit can be manipulated via creative accounting, covering both the traditional ways of 'smoothing' profits – for instance via stock and debtor provisions – and the relatively new and topical methods of manipulation, including sales loading and revenue swapping.

Chapters 6 and 7 move on to cover the controversial issues of asset valuation, showing how thinking has moved away from the traditional focus on historical cost to the concept of 'fair value', and the impact this change has had on the potential for judgement and manipulation. Chapter 8 covers the other side of the balance sheet – the liabilities – and includes mention of that most topical issue in the aftermath of the Enron scandal – the ways in which debt can be moved 'off-balance-sheet'.

Chapter 9 discusses the complexities and the judgements involved in accounting for 'business combinations', an issue that has recently become more important as businesses enter into joint ventures and strategic alliances, as well as the more traditional mergers and acquisitions. The final chapter looks at the state of accounting in the 'post-Enron' era and discusses likely developments in the future.

Throughout the book there are reports of examples of creative accounting in practice. A few of these examples go back in time to show that creative accounting is nothing new, but most are about revelations during the 12 months since the Enron case first hit the headlines, thus bringing the topic right up to date.

This book is suitable for both financial and non-financial managers who need to know about the nature of creative accounting, particularly those who are responsible for the preparation and analysis of published accounts. It should help everyone who reads it to see the judgement areas involved in financial measurement and to be aware of the potential for manipulation. Its comprehensive and practical nature demonstrates the skills and ability of MTP to provide user friendly and effective learning for managers.

Acknowledgements

The authors would like to thank Helen and Hannah Garthwaite, Chris Goodwin and Tina Webb for their valuable help in the preparation and validation of the text.

Abbreviations

ASB	Accounting Standards Board
CEO	Chief Executive Officer
DTI	Department of Trade and Industry
EPS	Earnings per share
FASB	Financial Accounting Standards Board (USA)
FIFO	First in, first out (stock valuation method)
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
GAAP	Generally accepted accounting practice (or principles in USA)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
JANE	Joint arrangement that is not an entity
JV	Joint venture
LIFO	Last in, first out (stock valuation method)
P&L	Profit and loss account
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standard (USA)
SPE	Special purpose entity
SSAP	Statement of Standard Accounting Practice
STRGL	Statement of Total Recognised Gains and Losses
UITF	Urgent Issues Task Force

1

Accounting – an inexact science

FUNDAMENTAL CONCEPTS AND PRINCIPLES

Creative accounting is nothing new. It has been a temptation and a problem from the moment that accounting principles were first used to report on business performance. There is an old joke about the accountant who is asked to add up two and two and who produces the response 'What would you like the answer to be?' It is an appropriate reminder that financial measurement is not an exact science.

In fact this old joke provides a good starting point because it leads to a helpful working definition of creative accounting. In this book we will work to the definition that creative accounting is: Allowing *the desire for a particular answer* to adversely influence objectivity and to justify the choice of inappropriate accounting methods.

Creative accounting in a publicly quoted company is about manipulating the financial numbers to arrive at an answer that meets the needs of the company management, rather than providing objective information for the external recipients – primarily shareholders.

One point to stress at this early stage is that creative accounting, like all wrongdoings, will never be erased entirely. If the management of a company is determined to deceive its auditors and shareholders, it will probably get away with it, at least in the short term. The managers control the data and have the power and the opportunity to deceive, so it is likely that there will always be a few who take advantage. But the application of good accounting principles, backed up by effective auditing, will reduce the chances and make it more difficult for those who wish to be creative.

It is also a question of degree. If we were to look at the history of most, and probably all, companies, there would be some examples of creative accounting, for example:

> *We've had a good year, let's increase the doubtful debt provision, and give ourselves a head-start for next year.*
>
> *We can't afford to make a provision for obsolete stocks this year, let's wait until next time.*
>
> *I know our depreciation rates need changing but this is not a good year to do it.*

This kind of judgement – often referred to as 'earnings smoothing' – is commonplace and usually acceptable, as long as it is not part of an intention to deceive over the long term. Limited massaging of the results to present a consistent picture to the outside world is regarded by many as part of the financial management of a public company; long-term deception is not. It therefore comes down to a question of scale and intent and this makes creative accounting so difficult to judge and to police.

BACK TO BASICS

To understand the practices and abuses of creative accounting, it is necessary first of all to understand accounting. This does not necessarily mean mastering double-entry bookkeeping – that is the mechanics of the process which cannot, on its own, prevent creativity. The books still balance when creative accounting has been applied, because it impacts both sides of the balance sheet. For instance, that inflated bad debt or stock loss provision will reduce both assets and shareholders funds by the same amount.

The understanding that is necessary is of the fundamental purpose of accounting – what it was originally designed to do, why the various financial statements are necessary and what they are meant to tell the recipients. These issues receive far too little attention, yet they are fundamental to the judgements that have to be made in every area of accounting. The purpose of financial reporting is the key to good accounting practice.

We will leave out the cash-flow statement from this coverage as it is the only one of the three key financial statements that should not suffer from creative accounting problems. Creativity may be applied to the layout and to the inclusions in each section of a cash-flow statement but the key figures – the closing cash balance and the change in cash during the year – are not easy to manipulate, short of deliberate fraud. Indeed the greater reliability of cash-flow statements has, in recent times, caused analysts and shareholders to pay greater attention to them, and to regard them as a good long-term check on the validity of the other two statements.

These other two statements are, of course, the profit and loss account (P&L) and balance sheet and we will examine their structure and their purpose at this stage, to provide a framework for the content that follows.

THE PROFIT AND LOSS ACCOUNT

This document – also called the income statement – has, and always has had, one fundamental purpose, to report to the shareholders on how the business is performing. This is achieved by matching sales against costs to arrive at the profit for a particular period. This matching process and the resultant profit calculation is necessary because cash-flow statements, though important for the reasons mentioned above, are not always good indicators of business performance in the short term. Cash-flow measurement suffers from the ‘timing problem’ which the P&L overcomes by collecting all the sales and costs of the period in question, to show the best possible indication of business performance.

This timing problem – the assessment of exactly when sales, costs and therefore profits have actually taken place – has become more acute as increasing numbers of companies have become publicly quoted in the many stock markets around the world. In the early days of accounting the merchants would wait for their ships to come home with the information on all transactions, before calculating profit. Now the pressure for half-yearly and quarterly accounts makes the task of reporting period profits ever more challenging and judgemental. Thus accounting standards and policies have to be produced, to provide the framework and guidelines for sales to be matched against costs in these shorter periods.

If it is accepted that the purpose of the P&L is to overcome this timing problem by achieving the best possible match of sales against costs, it follows that creative accounting, when applied to the P&L, is any practice that deliberately distorts the timing during that period. A clear and topical example is Worldcom's recent attempts to take out the employee costs from the P&L and show them in the balance sheet as if they were capital expenditure, even though they were clearly repair costs of the current period. This gave a false view of performance, making the profits appear higher than they really were in the short term. The auditors, Andersen, either did not see this manipulation, or saw it and ignored it. Whatever the intent, they and the directors of the company were allowing shareholders and others analysing the accounts to see information that did not present fairly the financial state of the company. This is an example of creative accounting at its simplest.

THE BALANCE SHEET

In this case the fundamental purpose of the financial statement is less clear-cut, because there have been conflicting views about the purpose of the balance sheet, particularly in recent times. This has arisen because of *the desire of some modern accounting thinkers to make the balance sheet into a statement that records the* value *of the business*, or at least parts of it. In the past there was no dispute about whether the balance sheet was a valuation statement – it was clearly understood and accepted that it was not. Indeed accounting lecturers in the old days have been known to ask their classes to chant in unison:

The balance sheet is *not* a valuation statement

Under this simple but logical view of things, the purpose of the balance sheet could be quite clearly stated. Whatever the layout – assets equals liabilities as in the US, or net assets equals shareholders funds as in the UK – it is a document of *control*. It shows the shareholders and others appraising the accounts, where the money to fund the business has come from and what has been done with it. The fact that the two sides balance, shows that every penny has been accounted for and that there is control within the business. All assets are accounted for at their *historical cost*.

If this principle is accepted, the issue of asset valuation does not arise. It is unnecessary and irrelevant to try to arrive at current values because that is not what the balance sheet is about. Asset valuation can be carried out as a separate exercise if helpful, but this is nothing to do with the balance sheet. Those who guided accounting practice in the early years adopted this view strictly and did not allow any upward revaluations of assets to their market value.

This simple view of life has changed and there are now many in the accounting profession – the UK and internationally – who believe that the balance sheet can and should value the business and its assets, tangible and intangible. This desire to achieve what we would regard as a doubtful goal had its origins in the 1970s when 'asset strippers' first came on the scene. Companies like Slater Walker took advantage of companies that had undervalued property assets in their balance sheet, taking them over and making a profit on their subsequent disposal. The tendency was to place the blame on the accounting principle of cost-based asset valuation, rather than where it really lay – on the under-performance of the companies concerned.

However, one consequence of this asset stripping was that UK companies with significant marketable property holdings began, with the acquiescence of the accounting bodies and their auditors, to revalue their land and buildings, creating a special reserve on the other side of the balance sheet. The accounting entry was simple – increase fixed assets by x on the assets side and create a new 'revaluation reserve' entry of x in shareholders funds.

This seemed to many observers to be a form of legitimised creative accounting but it did not seem to do too much harm. It was designed to boost the share price and deter the asset strippers, as well as impressing lenders and other creditors with the strength of the assets. It often achieved these objectives but it was also a watershed. It cleared the way for other asset revaluations and encouraged the belief that the balance sheet can do more than record the original, historical cost of assets. No longer was the purpose of the balance sheet clear – a new door to creativity was pushed open.

The belief that the balance sheet can and should, where possible, *value* the assets of the business has more recently been supported by significant moves from the UK accounting bodies to make this goal a reality, moves that are now central to the current debate about accounting principles and practice. A published *Statement of Principles for Financial Reporting*, produced by the Accounting Standards Board (ASB) in December 1999, has fuelled this debate and the resulting discussion has confirmed what has been obvious to observers for some time – that there is no clear agreement in the accounting profession about the conceptual framework that should guide accounting, auditing and financial analysis. One of the big four firms – Ernst & Young – has been particularly critical of specific weaknesses and inconsistencies in the ASB's position.

We will return to this key issue on a number of occasions throughout the book. As will become clear, we believe that this trend towards what is now referred to as *fair value* accounting, though well intentioned and likely to provide extra information, inevitably increases the opportunities and the incidence of creative accounting.

Case study 1.1

Amey Corporation

In October 2002 Michael Kayser of the Amey Corporation resigned as finance director after only two months in the job. The company denied that this was due to disagreements about accounting policies but said that Mr Kayser had been 'reviewing the company's accounting treatments and judgements'.

The company's shares fell from 59p to 23.5p on the day of the announcement and were then only 10 per cent of their value the previous March when changes to accounting policies were first announced. These changes referred to the treatment of bid costs and the way it recognised revenue from government contracts; they turned a reported 2001 profit of £55 million into a loss of £18.3 million.

In November the Financial Reporting Review Panel announced that it was considering whether to scrutinise Amey's accounts, following concerns about its accounting practices.

In December following a further review, the company's new acting financial director announced that its assets were to be written down by a further £85 million.

THE LINK BETWEEN THE PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Life would be much simpler if the P&L and balance sheet could be seen as separate unconnected entities, but they cannot. They are fundamentally linked by the process of accounting which determines that the accumulated retained profit to date has to be reflected as the excess of assets over liabilities and share capital, otherwise the balance sheet will not balance.

This link has traditionally been maintained by two fundamental accounting rules.

- A profit only occurs when there is an increase in net assets in the balance sheet, arising either from a business transaction or a change in events.
- That profit goes into shareholders funds via the P&L and thus maintains the balance of the two sides.

Therefore, it is not possible to stray from the fundamental principles and purpose of the two statements, without there being a potential problem of balance. Hence the need for special adjustments such as the revaluation reserve mentioned above, to keep that balance when practice strays from the underlying principles. This practice has become known as 'reserve accounting'.

A problem with establishing cast iron accounting principles is that they can rarely apply to all kinds of business. Another traditional accounting principle has been that a profit must be *realised* if it is to be shown in the P&L, and this rule was maintained by this practice of reserve accounting. However it became clear over time that in practice this principle could not be applied to every business. What about those companies who make money from day-to-day trading in shares, commodities and other financial instruments? How could their short-term performance be properly assessed without a balance sheet revaluation before disposal and the showing of unrealised gains in the P&L? Otherwise companies would simply indulge in that well-known creative accounting practice of the 'bed and breakfast' deal, selling assets on the last day of the year to record the profit, and then buying them back on the first day of the next.

Thus the basic principles were relaxed for such companies and there was another breach in the historical cost principle – market valuations of investments in the balance sheet and unrealised gains in the P&L, became the norm for such trading companies. This opened up a hornet's nest of valuation problems that were important to the highly complex and controversial case of Enron. Even the brightest and most conscientious auditor would have problems valuing derivatives and other complex financial instruments, never mind that it was Andersen!

FUNDAMENTAL ACCOUNTING PRINCIPLES

In the UK the responsibility of company management and the auditors to show the correct financial position of the company has traditionally been encapsulated in four important words – *true and fair view*. These words are fundamental to the practice of accounting in the UK and are enshrined in legislation via the various Companies Acts, the most significant of which became law in 1985 and will receive more coverage in the next chapter. These words are important because they oblige the directors and auditors to use their judgement when assessing the impact of accounting practice, and, if necessary, allow them to overrule technical issues and legal niceties. As we will see later, this is a fundamental difference between UK and US accounting practice that has come into prominence in the wake of recent scandals.

The practice of accounting has traditionally been guided by a number of fundamental principles that, if applied with honesty, common sense and integrity, should make creative accounting difficult to achieve in practice. These principles are mentioned in the UK Companies Act and thus have the force of law; they were originally confirmed in a well-known former *Statement of Standard Accounting Practice* – SSAP2, entitled 'Disclosure of Accounting Policies' (Choppings, 2002).

When the recent scandals involving creative accounting are examined, the conclusion can usually be drawn that the proper application of the following four principles by management and auditors would have significantly reduced the potential for creativity:

1 Prudence

When judgements of grey areas have to be made, the decisions should veer on the side of the answer that takes the prudent view, reducing profits in the P&L, and assets in the balance sheet.

2 Consistency

Accounting treatments should be consistently applied from one period to another, unless there has been a fundamental change in circumstances; in this case the impact of the change should be disclosed and previous period comparisons adjusted.

3 Accruals

'Accruals' is also referred to as the 'matching' principle. This confirms the purpose of the P&L mentioned above – sales and costs should be *matched* to arrive at a true definition of profit. If necessary, costs that have not yet been invoiced or paid should be 'accrued' to arrive at the best possible match.

4 Going concern

This principle supports the practice of valuing assets at their original cost (less depreciation in the case of fixed assets). The business is assumed to be a going concern unless there are reasons to believe otherwise. Thus market/realisable values are not normally relevant to a balance sheet, unless the assets are to be resold in the short term. When companies cease to be a going concern it is likely that asset values – for instance, fixed assets and stock – will be reduced in value because they will then be assessed on a 'break-up' basis.

In addition to these four principles there are two other rules that are important in their practical application and which have implications for creative accounting. These are:

Materiality

Accounting principles must be applied in all circumstances where the impact of the judgement is material to the scale of the results. If, however, the issue under judgement does not make a material difference because it is small in relation to the total size of profits and assets, the above principles can be waived in the interests of practicality.

No 'netting off'

Individual assets and liabilities, or profits and losses, should be shown separately and should not be hidden by netting one item off against another.

THE APPLICATION OF THE PRINCIPLES

In practice the application of these principles is rarely clear-cut, because they will often conflict with each other. For example the prudence principle would normally cause a company and its auditors to take research and development costs to the P&L, despite the fact that the matching principle would indicate a match with the future years when the benefits are to be felt. Matching would indicate the taking of assets of low cost – for instance calculators – to the balance sheet, whereas materiality justifies the normal practice of writing them off to the P&L.

The 1999 ASB paper mentioned above, and a later Financial Reporting Standard FRS 18, have questioned the modern relevance of some of these principles. For instance it is suggested that the prudence principle should sometimes be waived in favour of new concepts of 'reliability and relevance' and the consistency principle in favour of 'comparability'. Our view is that these challenges are more about the use of words than about real changes of principle and are unlikely to change the prudent, consistent, common sense approach of good, experienced auditors. This must be a good thing. If the management and auditors of Enron had put prudence before their perception of 'relevance', the results might have been very different. Our view is that the likely fall-out from recent scandals is that there will be a return to the old values and principles.

SUBSTANCE OVER FORM

The principle of 'substance over form' is also validated by the UK Companies Act 1985. It is closely related to 'true and fair view' except that it goes even further. It states that good accounting and auditing should be based on the view that *it is the real impact and intention of the transaction or situation that matters, not its technical or legal status*. For example, it should not be possible to hide an asset from the balance sheet by an agreement which, though legally a lease, is really a financial vehicle to borrow money. As we will see in Chapter 8, accounting rules now require that such 'financial leases' are treated as if the asset has been bought via borrowing, with the asset showing in the balance sheet and the amount of the lease commitment showing as debt on the other side.

The principle of substance over form allows the concept of 'true and fair view' to be applied whatever the legal status or structure. The downside of this principle is that it increases the grey areas and puts pressure on the auditors to look behind the facts to make judgements about the intentions. And the main source of information about those intentions is likely to be the management of the company, who may have their own creative accounting agenda.

This principle is the area where UK accounting practice varies most dramatically from that of the US, and the difference in approach has been highlighted clearly by the Enron case. There is no doubt that a key objective of the Enron financial director was to borrow money but keep it off the main Enron balance sheet by putting it through specially formed companies, thus misleading shareholders and analysts about their true financial status. He even boasted in accounting journals of his proficiency in devising a legal structure to get round the regulations.

We will see in Chapter 8 that if UK accounting principles had been followed, such debt would have had to be shown on the Enron balance sheet, because the specially formed companies – entitled Special Purpose Entities or SPEs – would have been classified as 'related parties', a classification based on judgement about the realities of control rather than the legal structure. This would of course depend on whether the auditors would have applied the principle which, in the special circumstances of Enron, might be open to question.

GENERALLY ACCEPTED ACCOUNTING PRACTICE

The rules of accounting come from two primary sources. Those that over time have become 'generally accepted' within the business environment, and those that are contained within published papers that are issued from time to time to deal with particular issues as they arise. Together these form the Generally Accepted Accounting Practice (GAAP) of the country concerned.

In the UK the concepts of 'true and fair view' and 'substance over form', provide the ongoing framework, while Financial Reporting Standards (FRSs) are published to deal with specific issues. We will say more about these in the next chapter. The combination of these elements creates a UK GAAP – the overall framework for accounting and auditing practice in the UK that has significant differences from US GAAP and from the practice of some other countries.

The ultimate ideal goal would be to have international agreement on the fundamental principles and the major accounting standards. There is an International Accounting Standards Board (IASB) and a number of international standards have been published (*see* Appendix 3), but to date their coverage and acceptance is patchy. The EU is leading the way on harmonisation by stating an intention to make international standards mandatory for major European companies by 2005, though this may prove easier to promise than to implement. And although following recent scandals the US accounting bodies have expressed a new willingness to revise their approach, it is unlikely that the fundamental differences between the US and UK/Europe will be resolved by then, in particular the conflict between their more technical and legalistic approach – there are 144 detailed US GAAP rules – and the UK's greater reliance on judgement and intention.

> In June 2002 Peter Wyman, the President of the Institute of Chartered Accountants in England and Wales, said that if the proposed move towards International Accounting Standards takes place, 'the UK would have to accept some reduction in the quality of corporate reporting'. This move is because of the desire of the International Accounting Standards Board to achieve some convergence with the US's more rule-based FASBs.

One problem about the emphasis on accounting standards and their enforcement by the auditors, is that it gives the impression that good accounting practice is all about technical issues which only accountants with their 'professional' expertise can understand. Technical arguments about esoteric issues sometimes endorse that impression. The reality is that the responsibility for good, honest accounting must rest clearly and unequivocally with the top management and directors of the companies concerned. We will pursue this issue in the next chapter.

2

Roles and responsibilities

DIRECTORS' RESPONSIBILITIES

The responsibility for the preparation of accounts is firmly with the directors and, through them, the management of the company. The legal framework for this will vary by country and in the UK is contained within the Companies Act 1985, which, at the time of writing, the Government has stated its intention to update. This Act requires that the directors of all companies shall 'each year prepare a balance sheet and profit and loss account which show a true and fair view of the state of affairs of the company'. Note the inclusion of the words 'true and fair view' which we discussed in the previous chapter; it is in this Act that they are given their legal status, and the authority to make judgements about what is true and fair.

The directors are liable for this together; there is no extra legal responsibility on chairman, financial director or chief executive. There is not even any extra responsibility for the person signing the accounts; he or she is assumed to do so on behalf of the board, whose members can only escape responsibility if they can prove that they took reasonable steps to prevent them being signed. Failure to do so and, therefore, being party to financial information that is not 'true and fair', involves breaking the law and is punishable by a fine.

The Companies Act goes even further and makes an interesting and remarkable provision to justify the true and fair view and to authorise the directors (and auditors) to make subjective judgements. It says that where compliance with other specific provisions of the Act would go against the principle of 'true and fair view' the directors should go for the option that is true and fair. This is a clear justification of 'substance over form' – even to the extent of *providing authority to avoid compliance with legislation and with accounting standards*.

The directors' responsibilities have been further reinforced by a number of reports commissioned by the Government following concerns about reporting standards and corporate governance. These reports followed several scandals that threw accounting standards into question – for instance, Maxwell, Polly Peck, BCCI – and were later built into reporting requirements. Two reports commissioned in the 1990s – The Cadbury Report (1992) and The Greenbury Report (1995) – were later consolidated into the Principles of Good Governance and Code of Best Practice (the 'Combined Code') in 1998 by the Hampel Committee. Though only voluntary, this code has strong power through the London Stock Exchange's requirement that all quoted companies declare whether or not they have complied with it.

This code is yet more reinforcement of the principles of substance over form and true and fair view. It says in a reference to accounting information that:

> *The true safeguard for good corporate governance lies in the application of informed and independent judgement by experienced and qualified individuals – executive and non-executive directors.*

It requires the directors to present a balanced and understandable assessment of the company's position and prospects, and to explain their responsibility for preparing the accounts.

Case study 2.1

Lernout and Hauspie NV

In April 2001 Lernout and Hauspie NV, a Benelux based company operating in the area of speech products revealed that 70 per cent of the sales of its Korean operation – amounting to over $100 million – was entirely fictitious. After an investigation by PricewaterhouseCoopers (PC) it was revealed that this was caused by the Korean sales managers who were trying to achieve aggressive sales-based bonuses. They raised bank loans and transferred the cash through third parties to give the appearance of genuine sales. The auditors – KPMG – did not spot this creative accounting and filed a lawsuit against the company for providing false information and preventing a proper audit.

AUDITORS' RESPONSIBILITIES

The same Act makes clear the limits and the extent of the auditors' responsibilities. Despite the tendency of commentators often to regard the auditors as the first source of blame as if they had prime responsibility, they do not have any legal responsibility for the *production* of accounts for a company – that is clearly with the directors. Their responsibility is to report on the accounts, to state whether they have been properly prepared and to provide an opinion on whether they show a true and fair view.

The auditors are required to carry out all necessary investigations that enable them to assess whether proper records have been kept, whether these tie in with the accounts and whether accounting standards have been complied with. If they find anything which conflicts with this, they must say so in their report; they must also say if they have been unable to obtain the necessary information to form an opinion. It therefore follows that, if the auditors have acted honestly and diligently in accordance with the above, they should not be held liable. Thus, though large audit firms may be a tempting target for litigation because of their deep pockets, they can only be held liable if there is negligence or fraud. Automatic liability cannot be assumed when things go wrong.

QUALIFYING THE ACCOUNTS

The practice of informing the shareholders of any concern about record keeping or accounting information is termed 'qualifying the accounts'. A clean audit report would have no qualification, stating that the accounts show a true and fair view of the state of affairs of the company. A qualification may be for two reasons – disagreement with the judgements made by management when deciding upon and implementing accounting policies (see later) and uncertainty about the extent and validity of the records kept.

This provides a significant amount of power to the auditors that should not be underestimated. Though the impact depends on the nature of the qualification and the track record of the company, it will always be something that management will try to avoid. At its most extreme a qualification can throw doubt upon the validity of the accounts as a whole and even question the company's viability as a going concern, which in turn could push the company towards bankruptcy. On the other hand a qualification at a relatively technical level, say following a disagreement about the interpretation of a new accounting standard, might cause little concern or comment.

Qualification is not something that auditors do lightly and, if there is a serious qualification, it will be difficult to maintain a good relationship thereafter. In practice it usually comes down to negotiation and it is in the interests of all parties to reach agreement. This does, however, create dangers and can open the door to creative accounting, because the outcome of these negotiations inevitably depends on the relative power of the two parties, and the amount they have to gain or lose.

It is true that the Companies Act 1985 ensures that the re-election of the auditors and the fixing of their remuneration are carried out by the shareholders but this provision has little impact in practice. Decisions to retain or change the auditors are in reality made by a company's directors so there is strong pressure to maintain a harmonious relationship and to present a united front to shareholders.

Case study 2.2

Robert Maxwell

Robert Maxwell had already been stated by a previous DTI report (1973) to be an unsuitable person to run a public company. Following his death and the collapse of his businesses, the 1995 DTI report (Thomas and Turner, 2002) made the following comments:

Cash was borrowed by the private side on a regular and unsecured basis from the pension funds beginning in 1985. This did not become known to the trustees of the funds. The accounts were 'window dressed' with balances brought to nil at the financial year-end to avoid disclosure. The pension funds were used on a regular basis to assist in the corporate strategy of the empire and to provide cash in exchange for investments which MCC … needed to sell. … These practices were known to Mr Kevin Maxwell as well as to Coopers & Lybrand … who were the auditors of the public and private companies and the pension funds. They also provided advisory services to Robert Maxwell in connection with the acquisition and disposal of companies.

THE OBJECTIVITY OF THE AUDITORS

Much has been made of the fact that the auditors in recent accounting controversies may not have been objective, because of their dependence on the client for consultancy work. Enron is again the prime example here; not only were Andersens receiving $25 million in audit fees, they were also receiving $27 million for non-audit services, even though their consultancy arm had already been floated separately as Accenture. This is by no means unusual and, though it has to some extent been reduced by the separation of the large audit and consultancy firms, the fundamental conflict remains. Auditors are expected to apply objective judgement and impose powerful sanctions against companies that are also a major source of their income.

This conflict is nothing new and can be even more of a problem when the auditors are smaller and less powerful than the big four accounting firms. At least Ernst & Young and PwC are not dependent on a few clients; their very size means that their client base and risk will be reasonably spread. Contrast this with the small or medium-sized audit firm working for a big company which constitutes a large proportion of its total business. Shareholder concern about this situation has led to its practical elimination as companies have changed to big firms as they move towards flotation. This has been a major factor in the consolidation and increasing domination of the big firms.

Yet, as we found out with the demise of Andersen, size does not guarantee truth and fairness and this is no new phenomenon. The Maxwell scandal occurred over ten years ago and the auditors involved were one of the big firms of the time – Coopers & Lybrand. Here of course another key variable came into play – one that is still clearly around today – the personal dominance of a charismatic and determined chief executive officer (CEO). People like this can frighten those around them, inside and outside the business, compelling them by force of personality to produce the results that are needed to meet their personal goals. This still seems to be a key factor in the equation, as evidenced by Worldcom, Enron, Tyco and numerous internet companies. Financial directors and auditors seem to find it hard to say no to driven top managers who are determined to show profit and share price growth.

A number of suggestions have been made to reduce or eliminate the problem, the most commonly quoted of which is to have compulsory rotation of auditors, say every few years. Naturally the major audit firms are against this and they will probably be supported by many of their clients who value the close relationships that inevitably develop. The main arguments against this idea are the loss of knowledge of the company which will be wasted each time there is a change – possibly making it more easy to deceive new auditors – and the impact of lack of competition on costs, standards and motivation. In the US the accounting bodies have already persuaded legislators to soften their original intention to enforce auditor rotation under the new 'Sarbanes-Oxley Act', which now only requires rotation of the lead audit partner every five years.

The outcome of the debate in the UK will be interesting to observe – the smart money is on there being no fundamental change, but a much stricter control of non-auditing work.

Case study 2.3

Perot Systems

In October 2002 Perot Systems announced that its earnings could be halved in the short term as a result of a proposed new accounting treatment for businesses involved in outsourcing and consulting. There is likely to be a new rule for such businesses, based on the 'percentage-of-completion' method, following a report from the US 'Emerging Issues Task Force' which is expected soon.

Previously the company had been taking most or all of the revenues on such projects at an early stage; when the new 'percentage-of-completion' rules come into effect, these will be spread over the time of the contract.

The company, founded by the former presidential candidate Ross Perot, said that adopting the new rules would require a restatement of earnings of between 25 cents and 35 cents per share.

ACCOUNTING POLICIES

The responsibilities of directors and auditors are not just about producing and checking a set of accounts on an ad hoc basis. They are also about specifying and regularly updating the company's accounting policies, so that GAAP principles and up-to-date accounting standards can be implemented logically and consistently. These accounting policies, which must be disclosed along with the accounts, are the practical means by which the application of the accounting principles mentioned in the previous chapter is carried out.

In particular they provide the framework for the 'consistency' principle to be implemented; the policies should be applied consistently year on year, unless there are fundamental changes in circumstances or new information that justifies a change. This is one of the most effective controls on creative accounting, because it provides the auditor with concrete justification for the rejection of changes to accounting policies as a way of manipulating results. The challenge will not only be – what is the right principle? But also – why are you changing your policies this year?

Accounting policies are at two levels – the higher level policies that are likely to be disclosed with the accounts, and the more detailed estimation rules. A good example would be depreciation. The accounting policies might state that assets are depreciated over their estimated useful lives on a straight line, historical cost basis and make reference to the policy (if any) on revaluation of land and buildings. Behind this statement, and usually not disclosed in the annual report, will be the detail, for instance the lives and terminal values currently assumed for plant, vehicles, computers, etc.

This means that, in order to interpret accounts effectively, shareholders and the analysts who advise them, must be able to understand the implications of accounting policies, particularly where the business is complex and where changes in policy take place regularly. There was a time when there was trust in the auditors to police creative accounting through the negotiations around such policies but this faith has been seriously eroded. The significance of what happened at Enron is not just that creative accounting was accepted by the auditors but that Andersen appeared to be proactively suggesting policies and practices which hid the reality of the company's financial position.

CONTROL THROUGH THE ACCOUNTING BODIES

It would be wrong to assume that the law, and the Companies Act in particular, is the only mechanism by which companies are obliged to report to shareholders and to follow good accounting principles. The Companies Act provides the legal backing in general terms but this is reinforced by the more detailed rules and standards produced by the accounting bodies; the six Chartered Institutes of Accounting operating in the United Kingdom (*see* Appendix 1). These six bodies have combined to create the Financial Reporting Council (FRC).

This body is financed one-third by the government, one-third by the accounting bodies and one-third by industry. Its role is to promote good accounting practice and to make recommendations to government about new legislation. It also provides broad guidance on priorities to the Accounting Standards Board (ASB), its subsidiary body that carries out the detailed work on areas that require investigation and on new accounting rules. We have already made reference to one of the many papers that the ASB has produced in the previous chapter.

It is significant in relation to the issues discussed in the previous chapter that the ASB has stated that its aim is to limit the number of detailed accounting rules and to rely more on broad principles, contained in Financial Reporting Standards (FRSs). This contrasts with the US, where there are far more standards with much more detailed rules and guidelines. The FRSs – and their predecessors the Statements of Standard Accounting Practice (SSAPs) – which are in force at the time of writing, are shown in Appendix 2.

The ASB also has a committee to address new problems – its Urgent Issues Task Force (UITF) – which typically addresses unexpected and unwelcome developments that cannot wait for the longer timescale involved in fully worked standards. Finally, there is the Financial Reporting Review Panel, which examines suspected departures from accounting requirements and is authorised by the Companies Act legislation to seek court orders to have accounts altered (though in practice issues to date have generally been resolved through voluntary compliance). The panel's reviews usually arise from representations by parties who have suspicions about the validity of the accounts and decide to bring these to the panel's attention.

This illustrates the substantial power of the FRC and these subsidiary bodies, and the potential impact on quoted companies cannot be underestimated. A topical example is the issue of FRS 17 on retirement benefits. This standard produced new rules on pension scheme valuations that have had a dramatic impact on the treatment of future pension liabilities and, through this, the profit levels of many major companies. One interesting consequence has been that some companies have changed the investment portfolio of their pension schemes partly as a result of the standard, with one company – Boots – even going so far as to convert all its pension funds into bonds rather than equities.

On the other hand, not all FRSs receive automatic acceptance and there may be challenges to both the logic and the practical application of new standards. There are frequent cases of companies deciding not to follow the rules or principles laid down, because they believe that it would mislead the shareholders or, if they are in creative accounting mode, because they do not like the impact on their results and their share price. In these cases there are difficult negotiations with the auditors about how this will be disclosed and whether it will take the form of a formal audit qualification.

An interesting postscript to this section is the news that the compulsory implementation of FRS 17 has now been suspended until 2005, awaiting the agreement of an international standard.

Case study 2.4

Boots

On 9 December 2002 it was reported in the *Evening Standard* (Sunderland, 2002) that John Ralfe, head of the Boots pension fund, had resigned. Ralfe was the man responsible for the decision to move the whole £2.3 billion fund from equities to bonds following the introduction of accounting standard FRS 17.

Ralfe was a strong supporter of FRS 17 and press speculation suggested that the resignation was caused by a dispute with the new finance director Howard Dodd over the company's intention to backtrack on the introduction of FRS 17, following the postponement of its compulsory enforcement. Boots denied that it intended to move the fund back into equities and said that 'we never comment on speculation about colleagues'.

OTHER DISCLOSURE REQUIREMENTS

There is a fine line between accounting and other disclosure requirements. The legislation which forms the basis of accounting principles also requires certain other information to be disclosed, information that would not normally appear in a set of accounts. For instance the Companies Act requires companies to disclose the number of employees in the notes to their accounts, something that is not part of typical accounts presentation and is not generally required in other countries.

The concern of many companies about making detailed disclosures as part of their reported accounts, is that it can provide competitors with information that will be useful to them. For this reason, and perhaps also because of a less justified desire to keep information from shareholders and the financial community, the art of creative accounting can extend to such areas. Companies use creativity to avoid giving the required information, or to make it meaningless. For instance the requirement to disclose gross profit and details of cost structure has led to some creative definitions; an example is Tesco defining gross profit as sales less all the costs of operating its stores, whereas many other retailers adopt the more normal definition of sales less only the cost of merchandise.

Nor is disclosure confined to legislation and the rulings of the accounting bodies. Companies that are quoted on the London Stock Exchange have further requirements for disclosure which go beyond what is required by law or by accounting rules. For example the need to declare compliance with the Combined Code mentioned earlier comes from the Stock Exchange requirements.

THE NATURE OF CREATIVE ACCOUNTING

There is a danger that, because of the complicated nature of some of the accounting controversies of recent times, creative accounting is assumed always to be complex and outside the day-to-day operations of the company. Nothing could be further from the truth. Most creative accounting is, and always has been, built around a few key assumptions and judgements that are nothing to do with 'Special Purpose Entities' or asset revaluations. Therefore, before covering some of these more complex areas, we will look at the routine but important issues of judgement within every set of accounts, that are the regular subject of discussion and negotiation between management and auditors. These are the topic of the next chapter.

Case study 2.5

AOL Time Warner

In October 2002 AOL Time Warner admitted that advertising deals in its AOL division had been accounted for inappropriately, causing the company to lower its revenue by $190 million and its earnings by $97 million over a two-year period. This had been discovered after an internal review of AOL's accounting procedures.

This announcement followed previous news in July that the US Securities Exchange Commission and the Department of Justice had also opened reviews of AOL's accounting methods.

Dick Parsons, chief executive said that 'even though the restatement represents a small portion of AOL's total revenues during the period, we have taken and do take the matter very seriously'.

What Mr Parsons did not say was that this mis-statement began before the merger of AOL and Time Warner and press speculation the following day suggested that this accounting problem might open up AOL to claims from Time Warner shareholders.

3

What would you like the answer to be?

CREATIVITY IS NOTHING NEW

With all the recent controversy about the unreliability of published financial information, there is a danger that creative accounting is seen as some new phenomenon. In fact the inexactness of the figures and the scope for creativity have been there ever since accounts were first produced. Creativity is not all about getting around the accounting standards and legal requirements described in the previous chapter; these add to the complexity and compliance may help to limit abuses but they are not the complete issue.

Nor have the current controversies all been caused by new and sophisticated ways of beating the system. It is true that the case of Enron was partly around accounting for complex trading transactions and their practice of creating new 'Special Purpose Entities' to keep debt off the balance sheet. But the other major scandal of 2002 – Worldcom – was about one of the most simple and old-fashioned of judgement areas – the definition of capital expenditure.

This chapter focuses on this and three other traditional judgement areas that have been around ever since accounting took its current form. It also covers the relatively new but now widespread phenomenon of 'exceptional items'. The contents of this chapter should make it clear that every set of accounts is based on subjective judgement and that, where there are differences of objectives and opinion, these can become the subject of difficult negotiations between the company management and its auditors. The reality is that the results are often determined by discussion, compromise and trade-off, rather than by considered accounting judgements.

Case study 3.1

Cisco Systems

In an article in *IndustryWeek* in February 2002, John McClenahen reported that Cisco Systems had reported a net income of $3.09 billion under 'pro forma' reporting, yet this became a loss of $1.01 billion under US GAAP rules. This was achieved by the omission of a number of expense headings that are required to be included for GAAP reporting.

CAPITAL OR REVENUE EXPENDITURE

We will start with this key judgement area, one that is fundamental to accounting principles and practice – is expenditure treated as a cost in the P&L or as an asset in the balance sheet? The question and the principle behind the answer are simple, the practice can be very complicated. The principle is that:

- capital expenditure is money spent for benefit beyond this year and goes to the balance sheet;
- revenue expenditure is consumed in the current year and is matched against sales in the P&L.

Whatever the treatment in the books, the expenditure is still cash spent, a reality that often seems to be forgotten in discussions about classification between the two categories. Sometimes the way in which the expenditure is classified for internal budgets is a big factor in determining whether the money is available, which obviously leads to creative accounting temptations. Which way this pushes the decision depends upon the balance between two factors – which budget has the most funds available (usually capital) and which has the easier authorisation process (usually revenue).

Among the questions that have to be asked and answered when deciding whether expenditure is capital or revenue are the following:

- How do we treat expenditure that is intangible but provides long-term benefit, items like research, advertising and training?
- What about computer software, is that capital or revenue?
- How do we treat installation costs of new plant and similar assets?
- How do we deal with major repairs, particularly those that enhance the value of an existing asset?

In answering these questions we come up against some interesting issues of interpretation of the four accounting principles described in Chapter 1. The first question could be answered by quoting the principle of matching, which would justify the treatment of such items as capital, spreading the cost of research over the future years when the benefit will be received. On the other hand the principle of prudence would suggest that their treatment should be revenue, because that future benefit may be questionable and subject to unknown factors which will determine success. Another factor pushing the judgement towards prudence is the historical tendency of accountants and auditors to be sceptical about the value of something that cannot be seen and touched.

Even where a principle and policy is agreed, there may be grey areas. It is generally accepted that installation costs of new plant and machinery are treated as capital, an example of the matching and going concern principles taking precedence over prudence. But there might be costs of preparing the building for installation – perhaps using your own labour to knock a hole in the wall to get the machine in. Is that capital or revenue? There is no perfect answer and different companies and auditors might make the judgement either way.

In practice these grey areas tend to be resolved by a four-stage process, a process which illustrates the general problem of controlling those who are bent on manipulating results. The stages are as follows:

1 The initial establishment of an accounting policy as mentioned in Chapter 2. This establishes the broad principles, which must be in line with accounting standards and must be applied consistently. These might say for instance that assets are written off on a straight-line basis over their useful lives; that computer software and research and development are written off to revenue; that plant installation costs are treated as capital. These rules are established when the company is formed and updated as new issues arise, through negotiation between the company financial management and its auditors.
2 The conversion of this policy into more detailed accounting treatments, for example the period over which capitalised items are depreciated – cars over four years; computers three; factory plant ten, etc. There would also be guidelines to help the application of judgement around the grey areas, for example there might be a rule that building alterations connected with installation are taken to revenue through a special projects account.
3 The interpretation of judgement areas as they arise, for example, how do we split a computer project between its hardware and software elements; how is a complex refurbishment split between its elements of repair and improvement? This is often done by individuals at the time of invoice coding or by snap judgements when the spending is authorised, and the control of these processes will depend upon the efficiency of management supervision and audit checks.
4 Consultation and negotiation with the auditors about any major areas of judgement that will have a material impact on results, either during the year or at the time of the audit.

Each of these four stages has the potential for manipulation and creativity by those who wish to impact the results. The establishment and change of an accounting policy is the most difficult stage to manipulate, because it has to be published in the annual accounts. It is possible however for management to put forward suggestions for change on the pretext of better accounting practice, when the underlying motivation is to make the results look more favourable.

For example: ‘We believe that the capitalisation of software more accurately reflects the changes to our business model and trends in the modern business environment’ can really mean: ‘It will make our profit margin and earnings per share look better than our competitors’.

Though the auditors usually watch such changes carefully and will be guided by the principles of prudence and consistency, it may be difficult to detect and stop the determined and skilful manipulator.

The second and third stages can be manipulated if managers allow the interpretations of their accounting policies to be influenced by their view of what the profit should be, or by their desire to obtain the necessary spending authorisation. In most organisations this happens to some extent on a day-to-day basis and the extent to which it matters is a question of degree and motivation. In principle there is no difference between a manager classifying a minor capital expenditure as revenue to avoid it going through the capital approval process, and Worldcom treating several billion dollars of repairs as capital expenditure to make its profits artificially high. In practice there is a world of difference, which the Worldcom directors may be able to contemplate at their leisure!

Case study 3.2

Worldcom

The 2001 accounts of Worldcom had to be restated. The internal auditors discovered that costs associated with network services and facilities, called 'line costs', were being treated as capital expenditure, whereas previously they had been treated as revenue expenditure through the P&L. These were clearly repairs to keep the cables in their present state and did not represent any improvement.

The amounts involved were initially stated as $3.05 billion in 2001 and $797 million in the first quarter of 2002. In November Richard Thornburg, appointed to oversee the company's bankruptcy, announced that his team had found other questionable accounting treatments and that the 2001 earnings might have to be restated again.

BAD DEBT PROVISIONS

This is a routine judgement area that receives little attention from the regulatory authorities, yet it is usually of key significance and is relatively easy to manipulate. Its impact on profit is sensitive in most businesses except those that sell for cash. The accounting impact is that the bad debt provision reduces the debtors in the balance sheet and creates a cost in the P&L of the same amount, thus having a direct impact on the bottom line. Those looking for creative accounting should make this one of the first questions they ask – what is the basis of your bad debt provision and how much is it?

Unfortunately the information provided in published accounts does not make it easy to answer that key question. In the US reporting requirements ensure that a figure for bad debt provision is quoted in the balance sheet or in the accompanying notes but do not require disclosure of the more useful figure – the amount charged as a cost in the P&L. In the UK and most other European countries there is no requirement from accounting standards to disclose and, therefore, little helpful information. Clearly, the company that lends money or offers credit to customers, has a good opportunity to overstate profits in the short term by making little or no provision, or to understate profits by deliberately over-providing. In practice the latter may get past the auditors' scrutiny more easily, because the concept of prudence will make them more likely to accept an over-provision.

In banks and other organisations in the business of lending, this is the big judgement area, which makes others look small in comparison. The basic question is – how many of the borrowers showing on our balance sheet are likely not to pay and how much should we provide for this eventuality? The potential for creativity applies particularly to the 'general provision' which is usually required, in addition to specific loans which have been identified as likely to default.

The dilemma of the auditor in this kind of situation is a good illustration of the creative accounting problem. How else can the auditors know of the need to provide for bad debts, other than by asking the company management? How easily can they judge if a bank's assessment of the risks of loans in certain countries or markets is soundly based? How does the auditor of a company supplying the retail trade know whether or not a major company is likely to go bankrupt – as K-Mart did in the US during 2001 – and what is a reasonable provision for this eventuality?

In practice the auditor can do no more than check the assumptions behind the provision, ask probing questions and assess the credibility of the answers. It is here that the accounting principle of consistency comes into play. The major part of the bad debt provision is usually based on some kind of formula, based on the age of the debts and the percentage probability of collection. The auditor should first check that this formula is reasonably rigorous and has been consistently applied, then try to assess whether there is a sufficient further 'general provision' to cover other unforeseen defaults. The latter will be judged on a combination of past experience, an assessment of current trading conditions and the application of the prudence concept.

It has to be accepted however that in businesses where bad debts are a major factor and where the situation is complex, any determined top management can probably mislead the auditors if they really want to, as long as they have the support and collusion of their financial colleagues. It is in these routine aspects of accounting negotiation that the role of the financial director is so critical; does he or she try to manipulate the bad debt provision to achieve the results that top management want to show and then try to justify this to the auditors, or does he work with the auditors to produce accounts which show the best possible true and fair view?

STOCK VALUATION

This is another routine judgement area that can be easy to manipulate and requires close scrutiny. The accounting convention is clear, its operation in practice is highly judgemental.

The principle is that stock should be valued at *the lower of cost and net realisable value*, which is a clear illustration of the prudence concept in action. It means that all stocks, whether raw materials, work in progress or finished goods, should be valued at what it cost to make or buy them, which in turn means that no profit is taken until a sale later takes place. However, if something happens to make such stocks worth less than cost – for instance they become obsolete and unsaleable – their value must be reduced to that lower amount. As stocks held are credited to cost of goods sold in the P&L, the judgements about stock valuation have a direct impact on profit.

Though 'the lower of cost and net realisable value' sounds straightforward and specific, in practice it can be a minefield of judgement and negotiation. It might be thought that the 'cost' element of this principle is easy to establish but nothing could be further from the truth. The further you go along the supply chain – from raw materials to work in progress to finished goods – the more difficult it becomes, but there are problems at all stages.

Among the questions to be asked are:

- Which raw material price do we take – the latest price, the average price over a recent period or our best estimate of the actual prices paid for the stock we are now holding?
- Connected with the above, do we assume a first in, first out (FIFO) stock rotation when calculating our estimate of the prices of stock now being held?
- What proportion of factory overheads do we include in work-in-progress and finished goods, do we take only the direct costs associated with the product or do we include all factory fixed overheads?
- What method of apportionment do we use to spread these fixed overheads between different products?
- Do we include any allowance for other overheads outside the factory?

The answers to these questions should be covered in each company's accounting policies, which should be applied with consistency and prudence. With regard to stock rotation, the FIFO principle is most common in European companies, whereas American companies have a history of applying last in, first out (LIFO). It is not part of the objectives of this book to go into the complex history and justifications of FIFO versus LIFO, except to make one important point which illustrates a key problem in the battle against creative accounting – the potential impact of change on tax liability.

Some US companies are still working on the LIFO basis, despite the fact that it is no longer regarded as the best way to account for stock. It was much more appropriate when inflation was high because a further consequence of the LIFO stock valuation treatment is that costs are shown in the P&L at the most recent prices. This in turn means that companies make less profit and pay less tax, because, unlike most other countries, LIFO is accepted by the US tax authorities. Thus any company making the change from LIFO to FIFO is likely to be faced with a large tax bill, which makes it unsurprising that creative ways are found to justify staying with LIFO.

Establishing cost is difficult enough; agreeing when realisable value is lower than cost and what that realisable value should be, is even more open to creativity. At least with the definition of cost you can rely on your accounting policies to provide consistent guidance; in the case of realisable value it is much more judgemental and therefore much more creative in two ways. First *when* the judgement is made that a particular element of stock is now worth less than its original cost, and second *by how much* it should be written down.

Though the most difficult examples of this dilemma are often around finished goods, we will use an example of raw materials to illustrate the basic problem and process. A company buys material X and pays £100,000 for it. Soon afterwards the product for which the material was required is discontinued and there is no other use for it. The correct procedure is for that £100,000 to be 'written down' to its realisable value as soon as these new facts are known. It is only acceptable to show the asset in the balance sheet at £100,000 if the material is later to be used in the product to create more value than its original cost.

Thus the company accountant, advised by his or her management colleagues, should immediately make an assessment of realisable value and make the necessary accounting entry. Assuming that the estimate of resale value is £70,000, the asset would be reduced by £30,000 and the P&L would have to take this hit straight away. That is what should happen; the reality may be very different, for instance the following questions might arise:

- Can we afford to take a £30,000 hit this year?
- If not, shall we just keep quiet and say nothing?
- Will the auditors spot it?
- If they do spot it, will they be able to check if we tell them it is worth £90,000?
- Should we take into account the fact that it will cost £5,000 to ship the stuff out before we can realise the £70,000?

Or, in different circumstances:

- We've had a good year, shall we write the material off as if it is worth nothing, then take the £70,000 as a profit next year when we sell it?
- Or, if this is likely to be queried by the auditors, could we make the value £30,000 or £40,000?
- Could we justify this lower value by saying that it is partly worn or damaged or that it will cost £30,000 or £40,000 to ship out?

These questions are the stuff of creative accounting in its day-to-day reality. They illustrate the fact that apparently simple accounting rules like 'the lower of cost and net realisable value' are in practice a minefield of judgement. For example, the extra issue raised by these questions – do we take account of the cost of shipping when considering realisable value? The correct accounting answer is yes, shipping costs should be taken into account because it is the *net* realisable value that should be established. Thus, if the cost of shipping is £5,000, the value should be reduced to £65,000. This principle adds yet more complexity to the valuation problem and to the difficulties of the auditors when checking assumptions.

ASSESSMENT OF LIABILITIES

The fourth key area of creative accounting is the judgement around liabilities and their inclusion in the P&L as costs. Accounting principles – based on the matching concept – say that all costs should be included in the P&L if they have been incurred, whether or not an invoice has been received or paid. Accounting for these items is known as the process of *accrual*.

There are many examples of creative accounting in this area. One of the oldest and simplest forms of manipulation is deliberately to hide invoices for goods or services for which there is no other documentary evidence, a clear and serious breach of good accounting practice. An easier and more common way to show higher profits is simply to fail to include any accruals for goods and services that have been consumed but not yet invoiced by the supplier.

Of course there should be a control system to ensure that written orders are produced and that the accrual therefore takes place automatically, but these are rarely foolproof. If the advertising department has made an order from an agency, or the training department has ordered a course from a consultant, there may be no formal record. This lack of control opens the door to a variety of ploys; for instance, leaving this cost out of the accounts and taking the hit next year, or making a deliberate overestimate or underestimate to massage the results either way.

There will be more about liability estimation in Chapter 8.

Case study 3.3

IBM

In February 2002 a *New York Times* article (Morgenson, 2002) suggested that IBM only beat its fourth quarter earnings target by showing a $300 million gain from selling its optical transceiver business. This profit was shown as a reduction of expenses rather than as a separate non-recurring profit on sale of assets and, therefore, helped to boost operating income. The article complained that when these earnings were reported, there was no disclosure about this sale or the way in which it was accounted for. Yet this profit represented 9 per cent of IBM's EPS in that quarter.

EXCEPTIONAL ITEMS

This new area of creativity has opened up over the past 20 years and has become a fruitful area for manipulation. As often happens with creative accounting, the intentions were good but the implementation has been problematic and has sometimes achieved the opposite to what was intended. At least now the term 'exceptional' seems to be accepted; there was a period in the 1990s when there were two types of adjustment – extraordinary and exceptional – and there were tortuous definitions to distinguish between the two.

Exceptional items are defined by FRS 3 as 'material items which derive from events or transactions … which … need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view'. A definition like that is bound to lead to differences of view and to temptations for managers who want to massage the profit figures. Typical examples of exceptional items would be expenses connected with an acquisition which did not eventually take place, payments to lawyers for fees relating to a legal restructuring of the holding company, or profits from selling off property.

The argument for their separation is sound, based on the matching concept. It would be misleading to show exceptional costs as a charge against one year's profit because it would distort the results, making the performance look poor when compared to competitors or against previous years. Similarly the 'one-off' profit would make the company's performance look better than it really is. This practice has been supported by stock market analysts who like to see such separations for their earnings per share comparisons and who would work out their own 'pre-exceptional' figures if the company didn't do it for them.

The fact that stock market analysts are so interested makes this adjustment particularly share price sensitive and thus leads to many disagreements about what is exceptional. Top managers who are looking for good headline profit numbers in the financial press and brokers' reports, will want to show the *costs* as exceptional and the *profits* as part of normal operations. The particular area of contention is restructuring costs, probably the biggest and most regular item receiving the 'exceptional' treatment.

This is a particularly difficult area because it all depends on the frequency of occurrence and therefore on the circumstances of each unique company. If restructuring of factories is taking place every year, it is unconvincing to claim that the costs are exceptional. Unilever received much acclaim from the financial press for declaring in July 2002 that it plans to take restructuring costs as a normal P&L item from 2004, when its major reorganisations will have been completed.

Another issue of contention can be profits on the sale of assets or businesses. Even a company as well regarded as IBM has received criticism for massaging its results by showing such income as part of normal operating profit. There have also been examples of companies applying this kind of creativity to the cash-flow statement, moving financial gains into operating cash flow, even though these were clearly not part of normal operations. In the modern business environment, even the cash-flow statement is not free from creativity!

We have heard of analysts and journalists talking cynically about this process as arriving at 'profit before bad things'. In the US it seems to have become accepted as the norm and the new term of 'proforma results' is used to refer to the adjusted profit line which top management wants shareholders to see. Standard and Poors, a leading credit rating agency, has recently responded by publishing its own definition of 'core earnings' and many stock market analysts will make their own adjustments, rather than those presented by the company.

THE TIP OF THE ICEBERG

Though these five areas are the day-to-day food and drink of creative accounting, they are not the whole story. There are many other areas of contention and potential manipulation, particularly in businesses that have special features and areas of complexity. The remaining chapters of the book will address some of the more topical and prevalent of these areas, and we will also include further coverage of the issues in this chapter.

However, one of the most regularly recurring factors in recent accounting scandals is one that we have not touched upon in this chapter – the definition of a sale. When is it correct to recognise sales and take them into the P&L? This important and, in some businesses, complex problem of 'revenue recognition' will be the sole topic of the next chapter.

4

Revenue recognition

THE IMPORTANCE OF SALES REVENUE

Revenue recognition is the practical application of the timing problem discussed in Chapter 1, that is, in which time period should sales revenue be recorded? This must be determined if there is to be a proper match against costs and a correct calculation of profit. In some types of business this will be easy to assess and there will be no major judgement areas; in others it is a challenging problem with huge potential for creativity.

However, the calculation of profit is not the only context in which revenue recognition is important. Even if sales revenue were to be misstated without an impact on profit – for example, via a self-cancelling adjustment to costs – it would still be important. In many sectors underlying sales growth is seen as a key relative performance measure. Investment bankers often use the reported sales revenue figure as one of the ways of valuing a company, particularly recent start-ups and businesses that are not showing a profit. Although the use of this method to value companies has been to some extent discredited by its use to justify high valuations for 'dot com' businesses, the level of sales is still an important focus of attention for analysts.

Case study 4.1

Bristol Myers Squibb

In October 2002 Bristol Myers Squibb was the subject of a US federal criminal investigation over drug sales to wholesalers. The investigation centres around sales in 2001 that raised distributors' inventories to 'unsustainable levels'. The investigators wanted to know if there was manipulation of sales and profits in order to achieve earnings targets. It has been estimated by analysts that extra sales of between $1 billion and $1.5 billion are involved.

The company claimed that its accounting treatment was appropriate but there is a strong belief among analysts that earnings will have to be restated.

At the time of this announcement, Bristol Myers Squibb's share price had fallen 60 per cent during the previous 12 months.

WHEN DOES A SALE TAKE PLACE?

The issue has received relatively little specific coverage in UK accounting standards and, as a result, UK GAAP provides welcome flexibility for those who wish to be creative. However, it does receive substantial coverage in US and international standards, and these provide more guidance for those in the UK who need to develop accounting policies. In practice however this issue is very industry specific and companies and their auditors will fall back on the fundamental principles quoted in Chapter 1, using their judgement about what represents a 'true and fair view'. This clearly makes the topic 'fair game' for creative accountants.

In conventional businesses that supply goods to customers, there is a simple principle – a sale is recognised when the goods are delivered. This is using what is referred to as the *critical event* method of recording sales. The delivery is the critical event, not the order, not the invoicing, not the eventual payment. This will apply to services as well as tangible products, though judgement and the potential for creativity arise when that service extends over a long period of time. In this situation the critical event method is not appropriate, and we will cover the alternative approach – the *accretion method* – later.

This emphasis on delivery date would seem to be simple and straightforward – the goods go out of the door and are no longer in stock, the P&L includes both sales and cost of sales to arrive at the transaction profit. There should be no scope for creative accounting. However, this underestimates the ingenuity of those who wish to manipulate results, particularly where there is pressure to meet sales and profit targets at the end of an accounting period. The US and international standards make certain further conditions for a sale to be recognised because of the well-known practice of 'sales loading'.

Like many areas of creative accounting, sales loading takes place to some extent in many respectable companies and is relatively harmless if carried out on a minor scale. For instance a sales manager is a little short of meeting his/her target and asks a friendly customer to take an extra delivery on the last day of the year. Indeed it could be argued that this is not creative accounting at all, merely effective selling. However, if it is done to a number of customers with the express intention of manipulating results, it becomes a more serious issue. And with the ever-increasing pressure to achieve short-term targets, it is a tempting avenue for managers and their accounting colleagues. It may also be difficult to control, because it often takes place at divisional, rather than central level.

It can also become yet another slippery slope. For instance, the following more serious steps might be taken:

- The seller agrees to take the goods back on sale or return, maybe on the first day of the following year – another version of what we called a 'bed and breakfast' deal in Chapter 1.
- The goods don't actually leave the seller's warehouse, they are invoiced to the customer with a false delivery note.
- A special price is given to compensate the customer for taking the extra products.
- There is undue pressure by powerful suppliers on distributors who are dependent upon them.

- There is an agreement that payment need not take place until the goods are sold on by the customer.

It is significant that the IASB believed this to be a serious enough issue to develop an accounting standard – IAS 18. This lays down a number of other criteria – beyond delivery – that must be satisfied, for instance that the risks and rewards of ownership must have passed to the seller and the sale must not be rescindable. Clearly this would disallow sales made under some of the circumstances mentioned above. This principle has also been adopted by the UK in FRS 5.

In principle UK companies and their auditors should be adopting this approach, using IAS 18 and FRS 5 as guidance, combined with the concepts of 'true and fair view' and 'substance over form'. However, even with these principles, it may be difficult to judge whether manipulation has taken place. Many such arrangements are informal and unwritten, and they need to be detected and assessed before a judgement can be made.

One final point to make about sales definition – the US and international rules say that sales should include only those that are connected with the company's *ordinary activities*, and this principle is generally accepted and adopted. Other sales – for instance of fixed assets or a separate business – should be shown under other income, as a profit or loss on sale. We mentioned in the previous chapter the criticism received by IBM because of its practice of mixing such transactions with operating profits.

Case study 4.2

MyTravel

In October 2002 the UK's largest holiday package tour operator, MyTravel, issued a profits warning and its shares fell 36 per cent overnight. The warning came as part of a trading update in which the company stated that its auditors, Deloitte & Touche, had refused to sign off the group's annual accounts unless it changed the way it recognised income from the sale of holiday insurance policies.

The company had always booked the full income from insurance policies immediately they were sold, whereas the standard industry practice is to wait until the customers begin their holidays. Tim Byrne the chief executive said that:

> *This is all about the auditors being prudent … and is not terribly helpful to us.*

The change in accounting policy took £15 million off MyTravel's bottom line. In October the Financial Reporting Review Panel began a preliminary assessment of the company's accounts.

Mr Byrne is no longer with the company.

SALE OR RETURN

We mentioned sale or return in the context of sales loading, but it is also a key judgement area for many businesses and one which is wide open to abuse and manipulation. A typical example of the accounting problem is what to do about a company – for instance in mail order – that offers customers the right to return goods within a month of sale and obtain a full refund. Can a sale be credited in these circumstances?

The US regulators, in accordance with their desire to lay down detailed rules, have developed a standard – Statement of Financial Accounting Standard (SFAS 48) – that provides some guidance. It specifies similar conditions to the international standard mentioned above and allows such sales to be recorded as long as there is a reasonable basis for the prediction of likely returns. In the UK the standard practice with such companies is to make provisions for likely returns, and the method would have to pass the usual tests of prudence and consistency. Clearly there is scope for companies to manipulate their profits, in much the same way as the bad debt provision mentioned in the previous chapter.

DISCOUNTS AND TEMPORARY PRICE REDUCTIONS

The treatment of discounts and temporary price reductions can be a key issue for the comparison of companies in sectors where such practices are the normal way of doing business. It is particularly important for those who are supplying the retail trade and the retail trade itself, because sales growth relative to competitors and to last year is such a key yardstick of performance. The accounting treatment will not impact the bottom line – it is a question of whether the amounts involved are shown as reductions of sales or as costs – but it can have a major impact on the financial analysts' assessment of top line growth.

The key question is – what is 'netted off' against sales? For example if a temporary price reduction is offered as part of a promotion, is the sale taken as the gross or net figure? In most cases consumer goods and retail companies would take the net cash received as the sales figure, but this is by no means universal. In recent times both Iceland/Big Food Group and Safeway have received criticism for showing free offers – buy one get one free (BOGOFs) – as if they were sales, then taking the same number as a self-cancelling adjustment in promotional costs. Clearly such an accounting practice would provide temptations for the top manager desperate to show sales growth towards the end of an accounting period; giving away two for the price of one would double the apparent short-term impact.

LONG-TERM CONTRACTS AND THE ACCRETION APPROACH

One feature of business over the past 20 to 30 years, is that it has become more complex. In particular there has been the development of many new businesses selling products and services which did not exist before – for instance computer software, consultancy services of many kinds, franchises and licences. This development presents challenging issues of revenue recognition, because the sale arrangements are often complex and are spread over a number of time periods. There have always been products and services that have been sold over long periods of time – for instance construction and shipbuilding – but the sales recognition issue has become even more important and complex as these new types of business have emerged.

In addition to this development, many of the companies involved in these sectors have been high-profile public companies with pressure to show improved sales and profits, so sales recognition has become important to them. There have been strong temptations to show as much sales and profit as possible in the short term, before the public flotation or while the share options can be taken.

Whenever sales extend beyond the current period, the accretion approach has to be applied. Again the US and international standards provide detailed guidance for its practical application and there is also a UK standard SSAP 9. These all confirm the acceptability of the 'percentage-of-completion' method which is widely applied. This allows companies to take a proportionate share of sales revenue, costs and therefore profits into the P&L as the contract progresses, as long as *the outcome can be reliably estimated*. The scope for judgement and creativity in this assessment is self-evident and those companies wishing for short-term profit may deliberately overstate the progress of the contract. In the construction business this is controlled by the requirement for architect's certification; in other businesses it may not be so easy to receive such precise quantification.

These standards provide a number of suggestions for tests that are commonplace in the accounting and auditing of businesses with long-term contracts, and these require measurement and judgement. The main criterion is usually the proportion of work carried out to the total project but other methods may be allowed if this is difficult to assess. For instance the international standard allows straight-line allocation in some cases and also mentions that the 'critical event' approach may be used here – a proportion of revenue being allowed when a particular stage is reached.

In the UK two distinctly different approaches have evolved and these will often result in very different short-term profitability outcomes for businesses in the same sector. One approach – the more prudent one – is to take all the profit on completion of the contract. The alternative – known as the attributable profit method – allows for the calculation of a proportion of the likely total profit each year. In either case the rule is that expected losses should be reflected immediately they are foreseen.

In practice each company in this type of business has to develop and consistently apply a policy to suit its unique requirements and agree this with its auditors; the scope for creativity depends on the auditors' ability to assess if it is the most true and fair option for that particular business. The outcomes of this interaction may vary between companies in the same sector and this can make the performance comparison of competitors a highly challenging task for the analyst.

Case study 4.3

Tyco International

In October 2002 Tyco International, struggling to reassure investors after the revelations of tax fraud by its former CEO Dennis Kozlowski, announced that it did not expect that its internal investigation would uncover major accounting fraud. It was a reflection of market concern that the shares rose on receipt of this assurance.

The company reported that it had lost $1.75 billion in the fourth quarter and was restating downwards last year's earnings by $135 million. This was due to an internal investigation which revealed that earnings had been overstated at its ADT alarm system operation. This was due to revenue on new security alarm contracts being booked too soon. The company has agreed in future to spread such revenue over the life of the contracts.

OTHER GREY AREAS

There are a number of other specific areas where revenue recognition judgements have to be made. In typical detailed US style, their standards provide quite specific guidance on a number of different types of transaction. We will illustrate a few of the most important issues here.

CONSIGNMENTS

The use of consignment stock is common in a number of sectors, for instance in the car industry where a manufacturer delivers stock to a dealer. The arrangement would typically be that the dealer does not immediately take ownership, but instead the title remains in the hands of the manufacturer. However, when the dealer either uses or sells a car, that event triggers payment to the manufacturer.

The question therefore arises, when does the sale take place? The answer, like so much in accounting is that it depends!

In deciding the date of sale it will be necessary to examine the consignment agreement to see where the weight of benefits and risks falls. Key issues will be how the right of return can be exercised, who bears the risk of obsolescence and when the price is set. The test will be similar to those mentioned above – the accounting policy should be determined by when the main risks of ownership are transferred from seller to buyer. Creativity of definition and information as a means of achieving early revenue recognition may well be a temptation for the manufacturer who is keen to show sales and profit growth.

INITIAL FEES

In some types of business it is usual for a supplier to charge an initial fee at the beginning of the provision of a service – for example, a consultancy project over several months or a bank collecting an initial arrangement fee. This initial payment would then be followed by further fees as the project progresses, the exact timing being determined by the nature of the contractual relationship.

There is a surprising amount of flexibility in accounting treatment and this leaves the door wide open to aggressive accounting policies and creativity. The US and international standards recommend that such fees be spread over the life of the contract by a number of possible methods but this practice is by no means universally applied. One reason is that it is often difficult to decide which element of the work the initial fee refers to – it may just be custom and practice to pay a certain percentage. Those who want to maximise short-term profit will obviously argue for an immediate and complete charging to revenue, which is the practice in many companies.

SOFTWARE

The development of software services as a major new area of business has raised some interesting new issues that have hardly been addressed by the accounting bodies. Existing practices and principles are difficult to apply to this different kind of business and there have been a number of different approaches, again making financial analysis and comparison very difficult. The US produced an accounting standard in 1997 and this has provided some principles to fill the vacuum left by a lack of specific guidance in the UK. In such circumstances UK auditors are likely to encourage their clients to work to the US principles.

The first issue is where a licence is sold for a future period for a standard product that requires little or no customisation. In these circumstances the full revenue can be recognised on the signing of a licence agreement, even though the benefit to the client is spread over future years. This is general practice but the US standard requires certain criteria to be met – signed contract, delivery made, no future obligations, fixed fee and evidence that it will be paid. The creative accountant, wishing to push such revenue through, might well gloss over the future maintenance obligations or the payment arrangements.

Where significant customisation is required the accounting rules for long-term contracts apply and the sales revenue and profit will be recognised over the life of the contract, using the 'percentage-of-completion' method. In practice there will be projects where there are grey areas – for instance the extent of the customisation of the standard product – and the management looking for short-term profits may play down the cost of customisation and emphasise the importance of the standard licence.

Case study 4.4

Qwest

In July 2002 it was reported that Qwest, one of the US's largest telecom companies, had overstated revenues by $1 billion over the previous three years. This was achieved by the way it accounted for 'swap' transactions, where it would sell capacity to a competitor and then immediately buy back the equivalent amount.

Because of the self-cancelling nature of the transactions the earnings for these years were not affected. However, the telecom sector is one in which top-line growth is regarded by analysts as a key factor in company valuations and these transactions are likely to have had a significant impact on share price over this three-year period.

REVENUE SWAPPING

Recent accounting controversies have revealed an increasing trend for companies to trade with each other by means of revenue swapping. This is a form of barter, exchanging one non-monetary service for another. Difficult accounting issues arise when deciding how these transactions should be reflected in the financial statements, particularly when they may really be artificial devices to inflate the apparent sales and profits. This type of deal has received publicity recently as telecoms companies – for example Global Crossing and Qwest – have sold future network capacity to each other by this kind of barter deal.

Those wishing artificially to boost revenue will put a high value on the 'sale', thus inflating the apparent sales and impressing analysts who are looking for sales growth. It might be thought that this would not impact reported profits because the other half of the deal would show as a cost. However this underestimates the ingenuity of the modern creative accountant. If the cost side of the deal can be capitalised to the balance sheet and written off over several years, there will be a benefit to the bottom line too.

There is an International standard – IAS 18 – and this states that, where the *goods and services exchanged are of a similar nature and value, the transaction should not be regarded as one which generates revenue*. In principle this should disallow the revenue swapping between telecoms companies or that other common practice in the Internet boom – the exchange of advertising between dot-com companies. In the UK the Urgent Issues Task Force (UITF) has now laid down a further condition to stop revenue being overstated by advertising swapping – there has to be 'persuasive evidence' that the sale would still have taken place if barter arrangements were not available.

If the swapping is of items of a different nature, then the accounting principle is that they should be applied to sales revenue at their 'fair value', with all the judgement and potential for manipulation that is involved in the interpretation of these two words.

FROM SALES, BACK TO COSTS

Chapter 3 covered some of the major judgement areas in the routine of accounting, mostly concerned with costs. This chapter has looked at the other side of the P&L, the definition of the sales against which these costs should be matched. However, before we leave the P&L and move onto the balance sheet, there are more cost issues to discuss, ones where there is yet more scope for creativity. These are the subjects of the next chapter.

5

The ascertainment of cost

COST TERMINOLOGY

We have covered the definition of sales but now need to return to the issue of cost ascertainment. Chapter 3 covered a number of key judgement areas that determine the level of costs, but there are many more issues that need to be resolved before the full P&L can be completed.

First we should confirm the terminology, as there is a lot of looseness and overlap of words in this area. Expense is another word for cost and these terms are commonly used interchangeably. 'Cost' more normally describes the money spent directly on the product, whereas expense is more typical of the costs of running the business in other ways, but this is by no means general. Another commonly used term is 'overhead', which can apply to the support costs in the manufacturing process – production overhead – or can be just another term for expenses, for example administration or sales overhead. Finally, to add to the confusion, all costs/expenses/overheads can be labelled under the general heading of 'revenue expenditure', to distinguish these from amounts taken to the balance sheet as 'capital expenditure'.

It will help understanding of the scope of this chapter to outline a typical cost structure within the P&L. This would be as follows:

Cost of goods sold

Materials

Labour

Production overheads.

Expenses

Selling

Marketing

Distribution

Administration

Personnel

Research.

Then there would be the 'below-the-line' items:

Interest

and

Taxation.

The above type of 'functional' cost analysis does not differentiate between the *types* of cost – depreciation, wages, rent, etc. Each functional heading would contain these categories within its detailed cost analysis; for example factory wages would be within production overheads drivers' wages within distribution expenses; office staff wages within administration expenses. During this chapter we will be referring to both types of cost classification – by function and by type – as they both have relevance to creativity.

MOTIVATIONS FOR COST MANIPULATION

Whatever terminology and classification of cost is used, the impact is the same – this year's P&L is charged with the full amount and profits take an immediate hit. This is why cost ascertainment is such a key area of potential creativity; there are so many motivations for reducing or avoiding amounts being shown as costs in the P&L. For example:

- the CEO who wants to meet the earnings forecast made to the stock market and thus maintain the share price;
- the director who is on a profit sharing bonus;
- the manager whose performance bonus is adversely affected by overspending;
- the manager who wants to spend the money this year but has nothing in his budget;
- the manager who has already overspent on the budget and wants to hide it.

There may also be motivations for applying creativity to increase rather than decrease costs, for example:

- the CEO who wants to keep profits down this year, so that there will be less pressure to exceed these results next year;
- the director who wants to spend everything that is in the budget to make sure that it is not cut next year;
- the manager who believes that the budget may soon be cut and wants to spend before this happens;
- the manager who has a training budget and wants to spend it to show that he/she is investing in people.

These motivations, and the creative accounting that results from them, are the everyday stuff of many major businesses. Those who turn a blind eye to 'acceptable' manipulations should be careful not to cast too many stones at the companies whose questionable practices have recently been revealed. It may be a question of scale and intent but a culture of creative accounting can develop from the sharp practices to be described below, and this can easily escalate into more serious wrongdoing.

THE SCOPE OF COST CREATIVITY

Every cost heading in the P&L has the potential for creativity. A number of the more traditional items were discussed in our overview in Chapter 3, and some will be developed further in the next three chapters, when we cover asset valuation and liability ascertainment. It will become clear that there are opportunities for creative accounting in every part of the business and for every type of cost. We will start with materials and work down the cost structure.

MATERIALS

Chapter 3 mentioned the minefield of stock valuation and confirmed that every increase in the value of stock results in a decrease in material cost. Thus managers wanting to increase profits may try to find ways of increasing stock valuations – hiding potential write downs, overstating resale values, deliberately overstating the quantities in a stock-take. The end of period stock-take is an interesting example of the difficult role of the auditor. It is traditional for one of the audit team to attend a stock-take, to see that all the necessary procedures are followed and that the count is carried out successfully. But in reality it is not difficult for ill-intentioned company people to mislead someone who does not know the business and is not in control of the process. It can become a token ritual to comply with the audit rules, rather than any real check on accuracy and honesty.

It is less easy to manipulate the cost calculations in the valuation because there should be an accounting policy to determine the method used and a check on consistency by the auditor. Thus it is not possible to say, 'let's change to FIFO this year because we need more profit' or 'let's include some new cost headings in the overheads so that we can increase the overhead allocation to stocks of work-in-progress and finished goods'. It might however be possible for a determined manipulator to make deliberate mistakes in the calculation of the prices of raw materials, though here you are crossing that fine line between creative accounting and deliberate fraud. If there are good controls in the company systems and effective audit checks, such dishonest manipulations are likely soon to be discovered.

One relatively easy manipulation of cost and profit is the deliberate failure to include in costs a delivery of raw materials that has been bought on credit. If the goods are deliberately missed off the delivery recording process and the invoice is hidden, nobody will know that the materials have ever been delivered. Yet the goods will either have been sold or will be included in closing stocks, thus increasing profit. Good control systems and audit checks should discover such fraudulent procedures, but someone who knows the system and has control of it, may find it easy to deceive.

LABOUR

Labour costs should be one of the most difficult costs to which to apply creative accounting. It is a straight cash payment to employees that is recorded in the bank statement and these are always the most difficult types of cost to manipulate. However, even labour has its grey areas, for instance:

- How much labour costs do we include in our valuations of work-in-progress and finished goods?
- Where there is a profit sharing or bonus scheme that has not yet been earned or paid out, what assumptions do we make about the future period and do we accrue for what has already been earned?
- What percentage do we add on for company pension contributions, where there is uncertainty about the company's future strategy towards payment (particularly where – as is happening in many companies at present – the company is considering abandoning its existing commitments)?
- What do we do about the time our staff have spent helping with the installation of new capital equipment, do we take this out of costs and make it part of the asset value? (This is normally allowed in accounting policies if the expenditure is sufficiently material.)

PRODUCTION OVERHEADS

With production overheads there are a number of issues. There is the amount of overheads taken to work-in-progress and finished goods and the grey areas around the definitions of repairs and capital expenditure, as described in Chapter 3. Another key area is the judgement around overhead accruals. For instance, how much do we put in for electricity costs for the last two months of the year if we have not yet received the bill? The unscrupulous manager and/or accountant might consider the following options to keep his or her costs down, particularly if there is pressure to keep within budgets, for example:

- Forget about the accrual and hope the auditors don't spot it; if the bill has been received, keep it hidden until the auditors have gone.

- Accrue the same amount as last year when you know that, for example, increased prices, colder temperatures or higher volume will have caused a substantial increase in energy costs.
- Produce spurious justifications for a lower accrual than last year, claiming false efficiency savings.

Of course all these actions will 'come home to roost' next year but the perpetrators of creative accounting usually work to a limited time horizon, shifting costs from one period to the next. They make the assumption that something similar can be done next year to make the figures look OK and it often turns out that this is only achievable by further creativity. Serious creative accounting and fraud are often revealed when such actions have accumulated over time and are finally discovered by internal or audit checks.

> *… GE was also aggressive in its financial and accounting practices … miscellaneous expenses incurred in the acquisition such as travel, meals and lodging were rolled into the purchase price … and amortized over a long period rather than being booked as an immediate operating expense … this GE practice had the effect of lowering current expenses and raising net income.*
>
> O'Boyle, 1998 *At Any Cost* (a book about the history of General Electric)

EXPENSES – DISCRETIONARY COSTS

When we look at expenses, we should distinguish between two types of cost. Those that are operational and short term, to do with running the business this year, and those that are more 'discretionary', providing future intangible benefits. Discretionary costs are for the longer term and are therefore very vulnerable to arbitrary reduction when times are hard. Examples of the latter would be research, advertising, training and development projects, costs which, it could be argued, might be better placed in the balance sheet rather than the P&L.

Before discussing the accounting treatment of these discretionary costs, it should be made clear that financial results can be manipulated in ways other than by creative accounting. They can also be manipulated by actual decisions to spend or not to spend, based on the short-term results that are desired. This is not creative accounting but it can be regarded as worthy of similar condemnation, for example:

- let's delay that new research project this year as there's not enough money in the budget;

- let's launch that new advertising campaign before the year end as money will be tight next year;
- let's run this training course in January rather than December so that it comes out of next year's budget.

This is not creative accounting but it is a deliberate attempt to manipulate results – it could be called 'creative spending'. It can easily and quickly move down the slippery slope to creative accounting when somebody suggests that maybe it is unnecessary to start the advertising campaign this year, let's just get an external agency to send a bogus invoice. Or to run the training course in December and ask the supplier either to delay invoicing or to produce an invoice with the wrong date. This sort of practice is surprisingly widespread, even in the world's most respectable companies, and suppliers who are dependent upon their powerful customers may find it difficult to refuse to go along with such deceptions.

Another issue around discretionary costs is the one mentioned briefly in Chapter 3, the extent to which they could and should be taken out of the P&L altogether and capitalised as an asset in the balance sheet. The matching concept would seem to justify this if there is substantial benefit for future periods but the prudence concept has caused this practice to be treated with great suspicion, particularly if it is driven by a desire to improve short-term profitability. The most famous case was in relation to research costs, when in the 1970s Rolls Royce, with the agreement of their auditors, treated the costs of developing new aircraft engines as assets in the balance sheet, thus helping to hide the seriousness of their financial position. This notorious example made accountants very wary of capitalising discretionary costs.

The current accounting rules do not allow such treatment, unless there are specific development costs relating to an identifiable project that is known to have future value. The accounting standard which allows this practice – SSAP 13 – is intended to apply only to businesses with major investments in product related development projects – for instance pharmaceutical companies – and is an exception to the normal rule that such internally generated intangible assets are kept off the balance sheet.

If this treatment is agreed, the depreciation period – called 'amortization' for intangible assets of this kind – has to be agreed with the auditors, based on the estimated period when the later benefit will be received. Clearly a management bent on manipulating results could exaggerate this future benefit and the length of the period ahead, though the unusual nature of this accounting practice is likely to ensure that it is carefully checked and negotiated by the auditors.

One final point to make regarding expenses is that creative accounting can and does occur between cost types and functional classifications, maybe because a manager wishes to pass a cost through a heading that has the necessary budget available. For instance there might be a deliberate miscoding of entertaining expenses to the marketing or product development budget, because an overspending will probably not be noticed there. This may be seen as less harmful than other forms of creative accounting because the overall impact on profit is self-cancelling. However, it still helps to set the wrong example and leads to a culture of poor control, another example of opening the door to more serious financial manipulations.

THE TIMING OF ADVERTISING

Advertising expenses have one particular feature that leads to interesting creativity practices. For major investments like television advertising, there is a timing issue. Many thousands of pounds may have been invested in a new advertisement and it is all ready to go but the product launch is not until the beginning of next year. Does this expenditure go into the next period to comply with the matching concept, or into this year to comply with prudence? The prudent accountant would argue that maybe the campaign will fail, in which case that advert has no future value and should be treated as an immediate expense.

The answer is that it depends on each company's accounting policy and a typical rule is that the full expenditure is taken as a cost in the *period when the first advert is shown*. Until then the expenditure is treated like a payment in advance, held in the balance sheet as an asset. This leads to an interesting practice that we have seen in several major consumer goods companies. Technically it may not be creative accounting, but in many ways it is worse than conventional manipulation. *Because the brand manager wants to treat the expense as a cost this year, the decision is taken to show the advert in one small region of the country just to comply with the accounting rules*. A single showing on one Milwaukee TV channel on the last day of the year justifies writing off the whole cost to the P&L!

Next year the reverse situation might apply because the brand manager does not have enough budget and the showing of the advertisement would therefore be delayed until the first day of the next accounting period. Thus the timing of a major marketing initiative is dictated by accounting rules. This is not the way that the advertising strategy of major brands should be implemented but it is the reality in some companies.

DEPRECIATION

Depreciation is a cost in the P&L that is different to all others. It is a book entry, spreading capital expenditure over its expected useful life. It can be seen as a separate cost heading or, if a functional cost classification system is applied, it will be contained within a number of functional headings – factory depreciation within production overheads, vehicle depreciation within distribution, office equipment depreciation within administration.

The potential for creativity on a day-to-day basis is limited because the assumptions about asset life are agreed and built into the accounting policies, as described in Chapter 2. Unless there is a new type of asset or a major project which has to be treated on a 'one-off' basis, the rules tend to be applied quite inflexibly, for example, ten years/10 per cent for plant, five years/20 per cent for computers, etc. One key judgement for assets that are likely to be sold for significant amounts at the end of their life, is the assumed resale value. For instance cars might be depreciated at 20 per cent over three years so that their book value is then 40 per cent, to correspond approximately to the trade-in value at that time.

Therefore the scope for creativity is mainly around persuading the auditors to agree to a write-down period that is not in line with the true facts of asset life and resale values. This may be easy to manipulate when the business is young because there is little evidence of what is likely to happen and the auditors are dependent on the opinions of management. As time goes on, creativity will become more difficult for two reasons. First, because a change to depreciation methods will have to be justified to the auditors as being due to actual experience and/or new circumstances; second, because there will now be evidence of real asset lives and sale values which will be available to the auditors.

If depreciation levels are fixed for each classification, the only remaining way of manipulating depreciation is in the classification of assets. This is not usually a major or widespread practice but there is potential for manipulation. If for instance buildings are written off over 40 years – a typical period – but furniture over (say) five years, it would be convenient for the manager who wants to keep costs down and profits up to code the furniture invoice to the building project and hope that the auditors fail to spot it. There might also be grey areas between buildings and furniture – for instance fitted cupboards could be coded either way depending on cost and profit preferences.

Case study 5.1

Sodexho Alliance

In September 2002 Sodexho Alliance, a French catering company, announced reduced profits, following which its share price fell by 30 per cent. It blamed a number of factors for the profit fall, including 'accounting anomalies'.

The accounting anomalies were in one subsidiary and the company produced the excuse that their auditors, PwC, had not been 'sufficiently vigilant'. The company announced that it was bringing in an accountancy expert 'to strengthen our analysis and internal audit process'.

A provision of €22 million had to be made to cover the anomaly.

INTEREST

The reader might think that at last there is a cost to which it is impossible to apply creative accounting. Interest is an item that is below the operating profit level and should, therefore, be less susceptible to manipulation by those who want to show good results. Also it might be thought that there is limited creative accounting potential because amounts of interest are clearly stated in bank statements and loan documents; all that is needed is a calculation of what is relevant to the accounting period, with accruals of the amounts that have not yet been charged or paid.

This way of thinking underestimates the ingenuity of the creative accountant. In fact there is a lot of pressure to manipulate the interest figure because, though it may not have an impact on operating profit, there are many analysts who look at this number very carefully. Those who analyze the P&L in order to assess a company's risk and stability for the purposes of credit rating and the granting of loans will look at the interest figure above all else. Indeed the relationship of interest to operating profit and cash flow is critical for the purpose of credit assessment and is often the basis of covenants between the company and its lenders. This means that if the interest exceeds a certain level, debts may become due for repayment or interest rates may rise – a strong incentive to find ways of achieving creativity!

One way in which this is achieved is by the practice of capitalising interest on major building projects, the argument being that money borrowed to build a new shopping precinct or retail store is just as much part of the capital cost as the bricks and mortar. To some this may seem rather spurious – particularly as it is often not possible to match a particular form of finance to a single asset – but it has been accepted as an accounting principle for businesses where major long-term building projects are part of their normal operations. Another argument in favour of this practice is that to show all interest in the P&L would make short-term results look misleadingly adverse, assuming that the income from the use, sale or rent of the property is to come in subsequent years.

Capitalising interest is allowed specifically by the Companies Act and by FRS 15 and is seen as normal practice in the property industry, especially the development sector. The argument is less strong in the case of retailers but interest capitalisation is still applied in many cases – for instance Tesco has been capitalising some of its interest for many years.

In the past this questionable accounting practice has led to some misleading results for property companies. During the property collapse of the late 1980s, a number of property companies capitalised their interest costs and thus maintained good profitability at a time when interest rates were rising and sale prices of new buildings were falling. Eventually a number of property companies collapsed after running out of cash, despite apparently healthy profit numbers. This is an interesting example of an accounting standard being developed for one set of economic circumstances, yet being less appropriate when the environment changed.

Of course a further way of manipulating interest cost is through the hiding of borrowing by means of leasing and other 'pseudo-debt' transactions, a widespread and topical practice that will be covered in Chapter 8.

TAXATION

It might be thought that tax is a fruitful area for creative accounting but it is not really so. It may be difficult to estimate the amounts owing in the future, but it is not easy for the company to manipulate the amount to be provided, short of negligence by the auditors or fraud by the company.

This is because there are definite rules and principles that must be followed in making tax estimates and the auditors will follow the tax authorities' guidelines. There have been controversial areas of judgement around the provision of deferred taxes, but the company's ability to influence the numbers has been limited by the issue of very specific SSAPs and FRSs by the accounting bodies.

THE LINK TO ASSET VALUATION

Every one of these judgement areas has a second implication – there will be a corresponding entry in the balance sheet. Where profits are manipulated upwards by creative accounting there must either be an increased asset or a reduced liability, otherwise the balance sheet will not balance.

Therefore, the next three chapters on asset valuation and liability definition are bound to contain a few areas of connectivity and overlap, though these will be kept to a minimum. There are also other asset valuation issues that are worthy of coverage in themselves, for instance:

- When are fixed assets re-valued upwards through appreciation, rather than downwards through depreciation?
- In what circumstances is computer software treated as an asset?
- How are intangible assets valued when they have been purchased specifically, for instance licences, trademarks, football players?
- How is the excess of an acquisition price over tangible asset values – the goodwill element – treated in the balance sheet?

The answer to these and other questions will be found in the next chapter.

6

Fixed asset valuation

THE SLIPPERY SLOPE OF 'VALUE' ACCOUNTING

If the accounting profession had been content for the balance sheet to retain its original purpose as described in Chapter 1 – to record the cost of assets and the funds that have been used to finance them – the problems of asset valuation would be less complex and less open to creativity. What the leaders of the accounting profession sometimes seem to overlook is that *the more you try to make accounting more 'sophisticated' and achieve objectives that it was never designed for, the more you open doors to creativity*. It happened in the 1970s when there were attempts to account for inflation in increasingly complex and questionable ways, which in the end had to be abandoned. However, the lessons were not learned and we have already described how, soon after, the practice of upward property revaluations began to be allowed in balance sheets.

We accept that the motivation of this 'value' approach to accounting is well-intentioned – to provide more information to those who analyze published accounts. However, it is a slippery slope and much of the content of this chapter is about the impact of the various subsequent attempts to place values on the fixed assets in the balance sheet. Once you change the question to 'how much is it worth?' instead of 'how much did it cost?' – you are into complex judgement areas which depend on many assumptions and challenge the intellect of the producer, auditor and interpreter of accounts. It is ironic but true that *the desire to disclose and report more relevant information often leads to more manipulation and less understanding*.

VALUING FIXED ASSETS

We will start with coverage of the accounting standards relating to fixed assets and the judgement areas required. In the UK FRS 15 states that both acquired and self-made fixed assets *may* appear on the balance sheet at cost and, as discussed in Chapter 5, this may include capitalised interest. Subsequent repairs and maintenance, keeping the asset operating to the same standard as when purchased, should *not* be regarded as part of the asset and should be charged to the P&L. As we saw with the Worldcom case, the treatment of repairs as an asset is a simple but effective means of increasing the apparent profit.

This financial reporting standard also allows that subsequent expenditure on the capitalised asset may also be treated as an asset and not charged immediately to the P&L if it:

- enhances the asset's economic benefit;
- relates to a major overhaul that restores the economic benefit already depreciated.

This provision is detailed confirmation of what was said in Chapter 3 – that the distinction between revenue and capital expenditure is a huge grey area for businesses with high capital intensity and it is not difficult to see how these two criteria could be creatively defined, depending on the profit outcome required. Who is to say whether economic benefit is enhanced or restored and what criteria should be used? This concept of economic benefit is important to the new thinking on asset valuation and we will return to it later in this chapter.

ASSET REVALUATION

The same reporting standard – FRS 15 – has legitimised the practice of asset revaluation by stating that companies *may* revalue their fixed assets if they so wish, an option which can be seen as evidence of the uncertainty – and for the creative accountant welcome flexibility – around fixed asset treatment. This option applies to all assets but is most normally adopted with property, where upward valuation movements are most likely to have taken place. As mentioned earlier, the 'profit' arising from upward revaluation does not go through the P&L but through the creation of a revaluation reserve in the balance sheet. However, following FRSs 3 and 15, it is now required that, in addition to the P&L, the accounts should show a Statement of Total Recognised Gains and Losses (STRGL) and the impact of such revaluations must be shown as part of this extra statement. The STRGL also contains other 'non P&L' items such as retrospective adjustments and foreign exchange gains/losses, and then reconciles all movements to the retained profit figure in the balance sheet.

The acceptance of voluntary upward property revaluations means that the interpreters of accounts can look at Marks and Spencer who revalued their properties in the 1980s and Tesco who did not, and make a completely misleading comparison of their relative profitability and asset structures. Such a vague and flexible rule also means that the perpetrators of creative accounting will be likely to choose to revalue only when it suits them – for example when borrowing is needed or when the share price needs a boost – rather than for the purpose of giving investors more information.

FRS 15 goes on to say that, if the revaluation policy is adopted, the valuations must be kept up to date. For non-property assets the revaluations do not need independent verification as long as there is a reasonable basis for a market valuation from publicly available information. In the case of properties other than investment properties – see below – the valuation must be carried out by properly qualified valuers (who may be internal) at least every five years, with interim valuations every three years.

Those who have had their house or car valued by more than one 'properly qualified' valuer will know of the likely differences of view about what is a true value and how these can be influenced by pressure and by different assumptions. This opens up all sorts of temptations to a management that wants to show a particular level of asset values in its balance sheet. However, revaluation is a two edged sword – one discouragement is that once the revaluation option is taken, the depreciation must be based on the revalued amount. Thus the price of showing an apparently stronger balance sheet is that there will be a reduced profit level.

> *Because of GE's enormous size and diversity, managers have at their disposal ways to manage the flow of earnings, and in particular to bolster them at times of slack demand. They can tap any number of hidden reserves to get income as needed and under generally accepted accounting principles have considerable discretion in assigning value to assets, which greatly influence the earnings they report. For instance, when GE acquired RCA the decision was made to allocate most of the goodwill … to NBC, which had the effect of increasing the television network's book value and, at the same time, increasing the profits GE booked when other RCA assets were sold.*
>
> O'Boyle, 1998 *At Any Cost* (a book about the history of General Electric).

DEPRECIATION

We have already touched upon depreciation in a P&L context and there is always a two-edged impact – the more that is charged through the P&L as a cost, the lower will be the asset values. The need to depreciate is confirmed by the Companies Act 1985, which says that assets should be depreciated down to their residual value over their useful economic life.

In Chapter 5 we mentioned the need for estimation and the scope for manipulation when the company is new and there is little experience of asset utilisation. There are also problems of judgement where there are unique assets with long, almost infinite lives. Over what period should you depreciate a retail store in a high street, indeed should you depreciate it at all? To many the practice described above – increasing property valuations for appreciation, yet continuing to depreciate thereafter – seems unnecessary and illogical.

This problem is solved by the normal practice of making a separation of property values between land, which will not normally depreciate, and buildings which normally will. However, where a property has been purchased as one combined package, this separation obviously requires judgement and those who want to reduce their depreciation charge may be tempted to make the land as high a proportion of the total as possible.

It may also be difficult to agree realistic depreciation rates for unusual assets that, if kept in good repair, will have almost infinite life. One example is BAA, which owns and operates a number of airports and has decided that its terminal buildings will be depreciated over 60 years, while tunnels, bridges and runways are taken over 100 years! Though these periods seem exceptionally long and the resultant low depreciation charges will benefit profit levels in the short term, it is difficult for an auditor to challenge them without evidence to the contrary, for instance that the airports might not exist that long, or that their use is likely to change. As the past 100 years have shown, technology can change in ways which make estimates of asset life and values that far ahead very questionable and difficult to predict.

THE CONCEPT OF IMPAIRMENT

Impairment is the likely loss in value of an asset, which would justify it being shown at a lower balance sheet value, because something has happened permanently to reduce its future economic benefit. The revaluations mentioned above are an option and usually apply to increases in value, but there is also a *requirement* to revalue downwards – and show the loss in the P&L – when there is evidence that impairment has taken place. However, the difficulty of making the judgement and the likely adverse impact on profit and shareholders funds, make it a fruitful area for creative accounting. The option for those who want to keep assets and profits high is to neglect to test and adjust for impairment, even when it is known to have taken place. The auditors should ideally carry out their own impairment tests but this will be difficult without management cooperation.

This potential for avoidance is confirmed by the vague wording of the standard – FRS 11 – which says that fixed assets need to be reviewed for impairment *when there is evidence that it may have taken place*. Furthermore, the process of arriving at the amount of impairment is complex and another good incentive for management to avoid the issue. Impairment is measured by comparing the book value of the asset with its ‘recoverable amount’. This recoverable amount is the higher of its net realisable value from sale and the amount of its future ‘value in use’, that is the present value of cash inflows from its future operation in the business. If, after these calculations, the recoverable amount is less than the book value, the difference has to go through the P&L as a loss.

This ‘value in use’ test can in principle be applied to any asset but in practice it is most relevant and feasible for those that are relatively self-contained in the business – for instance fixed assets involved in major projects. The FRS also allows valuation for groups of assets – termed 'income generating units' – if separate cash flows can be identified.

The concept of impairment is also highly relevant to the goodwill of businesses that have been acquired and we will return to this issue later in the chapter.

INVESTMENT PROPERTIES

There is one final point to make before we leave tangible fixed assets. The provisions above regarding properties apply to those companies that are using land and buildings in their business over the long term. However, there will also be 'investment properties' – those that are being held for their investment potential rather than for use by the owner. These *must* be revalued to 'open market value' each year by a properly qualified valuer (who may be internal) and at least every five years by an external valuer.

The accounting standard which first introduced this provision invited the Royal Institution of Chartered Surveyors to provide the valuation rules for its members who carry out such valuations. However, arriving at an 'open market value' has proved to be more art than science. In the case of Queens Moat Hotels in 1990, Weatherall Green, a firm of chartered surveyors, originally valued hotel properties at £2 billion, and then reduced this to £1.35 billion. A year later another firm – Jones Lang Wootton – arrived at a value of £861 million.

INTANGIBLES AND GOODWILL

One of the most significant developments in business over the past 20 years has been the increased appearance of intangible assets on the balance sheet, usually as a result of companies paying substantial premiums over asset values to acquire new businesses. This has been partly caused by the trend towards knowledge and service businesses but it also applies to what used to be regarded as traditional manufacturing operations. There are also cases where intangible assets are bought in other ways than through company acquisitions – for example the purchase of a brand, a publication, a licence – but it is this balancing figure of goodwill that is normally the cause of difficult and complex accounting issues.

An interesting example in recent years has been Unilever's acquisition of Bestfoods in 2000. The total consideration was €23.6 billion but only €2.1 billion of that sum represented net assets previously shown on the Bestfoods balance sheet. The remaining €21.5 billion – which in accounting terms has traditionally been termed as goodwill – is effectively the value, as seen by Unilever, of all the intangible reasons that companies buy businesses – for example brands, market share, people, growth prospects and the synergies which are expected to take place. Unilever would have determined this figure by their internal cash flow projections and their resultant willingness to pay the agreed price; the problem that has faced the accounting profession for many years is – how do you treat these massive amounts of goodwill in the balance sheet of the acquiring company?

Another question which is frequently asked – particularly by those who think the balance sheet can and should be a valuation statement – is how meaningful was the Bestfoods balance sheet before acquisition, when it only showed a value of €2 billion for a company that was clearly worth much more. This was because it did not show a value for the 'home grown' intangible assets, in particular the longstanding brands like Hellmans and Marmite. This question is made even more pertinent by the fact that the post acquisition balance sheet of Unilever now shows the Bestfoods brands as part of the goodwill figure but does not show anything for its home grown brands like Birds Eye and Persil.

This is further evidence that the desire to show asset *valuations* can lead you down a slippery slope. If, as suggested in Chapter 1, the balance sheet is merely seen as a statement that tells the shareholders how their money has been spent, the above anomaly is not a major problem. But once the balance sheet is seen as a valuation statement it is obviously anomalous and illogical only to show the valuations of acquired brands.

Thus there has been pressure to show all brand valuations in the balance sheet and marketing consultancies – notably Interbrand – have developed complex formulae to achieve this doubtful objective. Thankfully there is not yet an accounting standard which allows internally grown brands to be included but, if the latest thinking continues to prevail, it could be only a matter of time. Then there will be a whole new field of activity for creative accountants, which will add no value at all to the companies involved and their shareholders but will be a good source of business for the consultants concerned.

Case study 6.1

SFI Group

On 12 November 2002 it was reported in the *Evening Standard* (Armitage, 2002) that the SFI Group (formerly Surrey Free Inns), having already upset the market with a surprise profit warning, had now revealed a £20 million 'black hole' in its accounts and announced the departure of its chairman and previous chief executive Tony Hill. This announcement came soon after the group cancelled its final dividend and revealed that it was in breach of banking covenants.

Shares in the company, which owns the Slug & Lettuce and Bar Med chains, closed at 31p, compared to the year's high of 237p. The shares will remain suspended until a financial review by PricewaterhouseCoopers and the chief executive is complete.

The company statement said: 'Over a number of years there has been a significant overstatement of current assets and understatement of liabilities of the group.'

ACCOUNTING FOR GOODWILL

The rules on accounting for the goodwill arising from acquisitions have long been the subject of debate and of differences between countries; indeed it was, until 1998, the major difference between UK and US practice. In the end the UK lost the argument and in 1998, there was a change that brought us into line. Prior to this change, the normal UK practice had been for the total balancing figure of goodwill to be written off directly to retained profits in one year and never to be shown as an asset in the balance sheet. This approach involved an excessively prudent view about future value and was also hiding from the shareholders the record of the total money that had been spent on acquisitions on their behalf.

This led to a field day for creative accounting because a great opportunity to hide costs and increase profits was discovered. The UK accounting standards allowed restatement of the acquired company's balance sheet assets to 'fair value' so creative accountants hit upon this great idea. If you could reduce the net asset values of the acquired company by making provisions for the future costs of integrating the acquisition, you would show a higher goodwill figure. And as this could be written off direct to retained profits without showing in the P&L, it would not be so obvious to analysts and shareholders. Then later on, when the money was spent, it would not have to show in the P&L because it had already been covered by a provision.

Some simple figures will illustrate the issue and the potential for manipulation.

A buys B for	£100 million
B's tangible assets are	£45 million
Goodwill is	£55 million
A decides to make a provision for expected losses on integrating B's assets into A	£10 million
Thus reducing tangible assets to	£35 million
And changing the goodwill to	£65 million

If the provision was genuine, this practice could be justified as a reasonable statement of the situation, but then flagrant abuse started to take place. All sorts of costs, some of which were only vaguely connected to the acquisition and some of which were totally spurious, started to be provided for and taken off the acquired asset figures. Even worse, some companies deliberately over-provided for such costs and, when the money was not spent, took the saving as a profit in the P&L in subsequent years. This became one of the most outrageous areas of creative accounting in the 1990s and showed once again how the acceptance of 'value' as a balance sheet concept is likely to lead to problems of abuse.

This practice is now less widespread for two reasons. First, the direct write-off to retained profits no longer takes place – see below – and second, a new accounting standard, FRS 7 Fair Values in Acquisition Accounting, was introduced in 1994 to deal with this problem. The rule now is that only liabilities that have already been committed prior to the acquisition may be provided for in establishing the fair value and, therefore, the balancing figure of goodwill.

The UK method of direct write-off to retained profits was discontinued with the harmonisation to the US standard in 1998. Goodwill now has to be taken into the balance sheet as an asset and amortized in a similar way to the depreciation of tangible fixed assets. However, many post-1998 balance sheets now seen by shareholders are close to meaningless *because retrospective adjustments were not made*; the goodwill from acquisitions before 1998 remains hidden, whereas those after that date are shown in the balance sheet at the price paid, less amortization.

In the UK goodwill is now amortized over a maximum period of 20 years and this cost goes through the P&L every year. This 20-year period compares to the US's long-standing norm of 40 years. However, it should be stressed that these periods are maxima rather than required standards and many companies, particularly those in the high-tech sectors, have written off their acquisitions over much shorter periods. One other difference between the two countries is that the UK allows companies, in exceptional cases, to assume infinite life if this can be proved to be the most likely future outcome, and such an assumption would justify zero amortization.

Clearly this whole area has enormous potential for creativity, as the period of write-off depends on a management judgement of how long that acquired business will continue to exist and provide value as a separate entity, an assessment that requires many assumptions and future projections. To make things even more judgemental, there is a further provision that companies are allowed to split away from the goodwill figure certain identifiable elements of that intangible value – for instance brands, intellectual property, research projects – and value them at market value, using a 'reasonable valuation method'.

There is one further factor to add to this pot of complexity and that is the concept of impairment mentioned above. FRS 10 says that, before the book value of goodwill and other intangibles at cost less amortization can be accepted, there must be an impairment test to check if that value can be justified by future economic benefit. In other words the balance sheet value must be justified by the present value of future cash flows and these must equal the book value or more. If a lower economic value is assessed, that lower figure must be included. This applies to the first year after acquisition and to any year when significant changes have taken place.

One further point to note is that, because the impact of goodwill amortization on results can be so substantial – and the fact that it is not a cash flow of the current year – it is normal for companies and analysts to show profits at operating profit and net earnings levels, before and after goodwill amortization.

With all this mess of judgements and choices – and, therefore, the likelihood that the more unscrupulous companies will choose the options which show what they want others to see – it is questionable whether the balance sheets of companies that have been involved in a number of acquisitions, can mean anything to the average recipient. Only those who know the accounting rules and study what the company has been doing in detail, can have any idea what is going on.

There is one final postscript to add to the confusion. Just when the UK and US seemed to have achieved some harmony around goodwill treatment, a new US accounting standard – FASB 142 – was introduced in 2002, stating that goodwill should no longer be amortized at all, *unless there is evidence of impairment*. Thus the 40-year amortization write-off has ceased to operate. It is now highly likely that some European companies, concerned about the impact of goodwill amortization on their bottom line, will use this as an excuse for changing their accounting policy, thus making it even more difficult to make comparisons. This one will run and run!

OTHER ACQUIRED INTANGIBLE ASSETS

We mentioned earlier that goodwill following an acquisition is not the only context in which intangible assets can be purchased. To end this chapter we will cover two examples of such purchases which raise interesting issues – computer software, including websites, and football players.

In the early days of computers, the accounting treatment of computer software was not a problem. Most of the cost was hardware and the software was the minority proportion of the total asset investment. It was either integrated in the total cost or written off to the P&L because it was immaterial to the total financial position. Then hardware became cheaper and software began to be the higher proportion of the total cost, as major investments were made in software for financial and information systems.

Initially software was rarely treated as capital expenditure because of the historical reluctance of accountants and auditors to allow intangibles into the balance sheet, because they cannot be seen, touched and checked. However, as investments of millions of pounds in software systems became commonplace, accounting policies had to be developed, otherwise profits would be distorted by major software investments in particular years. There is now a specific reference to software in FRS 10, which states that software development costs that are directly attributable to bringing in a computer system can be treated as capital expenditure.

The Urgent Issues Task Force addressed the related issue of website costs – a good example of their role as providers of immediate guidance for issues which arise from changes in the business environment. They produced the rule that planning costs go to the P&L but the cost of the domain name, software, design and content may be capitalised if there is an 'enduring asset delivering benefit' and if the expenditure is identifiable, commercially viable and capable of delivering value. Once again it can be seen how the development of new rules often leads to a requirement for even more judgement to be used.

Accounting for football players is even more interesting. The tradition was for the cost of transfer fees to be written off as a cost in the P&L in the year of purchase, thus showing no asset in the balance sheet. Though this could be seen as excessively prudent, at least it prevented embarrassing questions about the balance sheet value of doubtful deals. It also prevented the anomaly of showing a balance sheet value for purchased players while showing zero for the home grown ones.

Two developments took place in the 1990s, which changed things. First, accounting standards started to allow the capitalisation of other intangibles; second, a number of football clubs were floated on the stock market and became very aware of short-term profitability. Now it is quite normal for players, or to be strictly correct, their contracts, to appear on the balance sheet as assets, and to be written off over the period of their contract. Tottenham Hotspur led the way, Paul Gascoigne was among the first to appear, and many others have followed. One can only speculate about the discussions that go on with auditors about the application of impairment tests in this context, particularly where the player has not met expectations. The creative accountant who wishes to avoid an impairment write-off might well exaggerate the form and potential future resale value of the 'asset' who has become a liability!

This issue illustrates once again how the balance sheet is a most unsatisfactory way of showing the value of assets for the business as a whole. Manchester United's balance sheet will be showing the value of purchased players such as Diego Forlan and Fabien Barthez, while showing no value for home grown David Beckham and Ryan Giggs. Only those who accept the balance sheet for what it was always intended to be – a statement of where the shareholders money has been invested – can be happy with this situation.

MORE COMPLEX ASSETS

Though some of the above may seem complex, it is not the end of the story. There are other assets that pose even more difficult problems – investments in shares and other financial instruments. These problems of valuation have become major sources of controversy in recent times and are covered in the next chapter.

7

Other asset valuation issues

The previous chapter illustrated the problems of fixed-asset valuation in circumstances when, by choice or by regulation, companies have moved away from the principles of historical cost accounting. This may have seemed complex but is relatively straightforward when compared with the valuation problems of certain other assets. It is impossible, in a book of this size, to deal with all asset valuation issues so we will merely highlight some of the more interesting areas with potential for manipulation. We will start by looking at the impact of currency fluctuations.

VALUING MONETARY ASSETS

Currency fluctuations have a major impact on asset valuation in any company that does business in more than one country. It is a broad and complex area and we will focus on a couple of typical issues where there is most potential for creativity. To start with a simple example, when a sale is made to another country on credit and payment is due in that other country's currency, at what value should the debtor be included in the balance sheet? This does not pose too many problems or opportunities for creativity because there is a simple and generally accepted rule for the currency translation of balance sheet items – *these should be included at the closing exchange rate*. Thus an exchange rate movement between the date of a credit sale and the period-end causes a profit or loss during that period, which must be accounted for immediately.

The more judgemental issue is whether such exchange differences should be taken into the P&L as a profit or loss, or written off directly to retained profits. It is now laid down in SSAP 20 that such items must be shown in the P&L as part of the company's trading operations and this is generally accepted as the right treatment. However, there are past instances of this being the mechanism for serious misstatement of results, the most serious and high profile case being Polly Peck. This company incurred substantial exchange losses on overseas borrowing but only showed these through a direct transfer to retained profits. Thus the shareholders were misled by the apparently high margins showing in the P&L and did not realise that, in real terms, the company was not trading profitably.

A further problem is that, in practice, every sale and debtor cannot be accounted for individually as the year progresses. Sales to different countries may be made every day of the year and it would be impractical to take the differences between sale date and period end date for each one. Thus average exchange rates are used to calculate the profit or loss on such transactions and judgements have to be made about whether rates are changed daily, weekly or monthly. The scope for creativity is certainly there for the determined manipulator, particularly as the calculations are likely to be complex; however, at least the exchange rates are in the public domain and can be checked by the auditors for consistent application.

VALUING OVERSEAS ENTITIES

Here the situation becomes more complex because the accounting treatment depends on the nature of the entity, in particular the extent to which it is dependent on the holding company for its operations. A good example of a company with this type of dependency would be a sales branch of the holding company. The test is the extent to which the overseas entity is dependent on the economy of the holding company, a clear issue of judgement and potential creativity.

This distinction is important because there will be differences in the closing exchange rates from one year to another and, when the assets are translated in the holding company's balance sheet, there may be substantial gains or losses. The significance of the dependent versus independent distinction is that, in the case of *independent entities* – for example, subsidiary companies with a separate management and legal structure – exchange differences caused by asset translations can be taken direct to retained profits, without showing in the P&L. In the case of *dependent entities*, such differences must be accounted for as a gain or loss through the P&L.

One possible manipulation for a company wanting to maximise profits, would be to define entities where there is a currency gain as dependent and those where there is a loss as independent, thus taking maximum benefit through the P&L. One further area of potential creativity is the choice allowed by the accounting standards; for certain P&L items companies may choose whether to convert at an average rate for the year or at the closing year end rate.

FINANCIAL INSTRUMENTS

The valuation of financial instruments and securities is another area of high complexity and potential creativity. How do you value a government bond or another company's shares in the balance sheet? When do you show the profit or loss? If you take the profit or loss before realization, do you show it in the P&L? What do you do if there is no obvious market price available in the public domain, for example shares in unquoted companies?

These questions are difficult enough to answer for relatively simple financial instruments like bonds and shares; they become many times more problematic when the financial instruments are more complex, for example the ubiquitous 'derivatives' which have received so much publicity since the Baring collapse. A derivative is a financial instrument that gives the holder the right or obligation to buy or sell a given product, at a given price, on a given date, sometime in the future. This right or obligation can lead to a future economic benefit or liability, the amount of which will be dependent on the occurrence of a particular happening. Derivative is a generic term that includes options, swaps and futures.

In the UK there is no specified method of treatment and this obviously opens up options for creativity. FRS 13 merely states that the method used must arrive at a 'fair value' and then places great emphasis on disclosure of the method used. However, the International Accounting Standards Board has released a standard on this topic – IAS 39 – and in the absence of a UK statement on the subject, a number of UK companies have adopted this standard. It is more 'rule based' than previous international standards and confirms the principle of fair value, as well as setting a number of guidelines for recognition and measurement.

The scope of financial instruments in this context includes:

- Financial assets or liabilities held for trading – derivative instruments are always deemed to be held for trading unless shown otherwise.
- Securities which can be held to a maturity date, for example corporate bonds and gilts.
- Loans and receivables originated by the company.
- Other financial assets which are available for sale.

The rule for recognition is that financial assets appear on the balance sheet as soon as the company becomes party to a contractual obligation. For example, even if no cash immediately changes hands on entering into a futures contract, the asset and liability must be shown if there is an obligation to buy or sell a commodity or financial product at some point in the future. Thus the accounting and auditing team need to have a high level of control to ensure that all transactions are properly recorded and reported; scandals like Baring and Allied Irish Bank show that, in some trading subsidiaries, these controls are not always as good as they should be.

The rules for measurement state that, when first acquired, all financial instruments must be shown at cost and this can include trading costs. For subsequent measurement – starting with the next period end – the rules state that, apart from unquoted equities whose fair value cannot be established, financial assets held for trading should be shown at fair or 'arm's length' value. The standard also requires that profits and losses should *go through the P&L at the next period end*, even though they are not yet realized.

If the financial instrument is not being held for trading – for example, a government bond which is being held to maturity – the valuation should be by means of a calculation of the present value in relation to the maturity date. The same will apply to any money lent to others by means of financial instruments that are repayable at a later date.

Case study 7.1

Enron

An Enron company, EES, contracted with Quaker Oats to supply energy and maintenance workers to 15 of its plants over a future 10-year period. It guaranteed savings of $4.4 million from one year's energy bill. Enron forecast a profit from the 10-year contract of $36.8 million. However, due to its 'mark to model' policy the contract was valued upwards allowing Enron to book $23.4 million profit before the contract had even started.

'MARK TO MARKET' VALUATION

IAS 39 reflected what had been going on for some time in trading businesses, the practice of marking up financial instruments to market price and taking the unrealised profit or loss to the P&L. This practice was an acceptance of the reality that trading companies are different and that the principles of conventional, historical cost accounting do not apply. A failure to accept this reality would only lead to that well-known creative accounting practice of the 'bed and breakfast' deal as mentioned in Chapter 1. In the 1970s, before mark to market treatment was allowed, many companies used to beat the system by selling the instrument on the last day of the year – probably to their own broker – and buying it back the next day.

So 'marking up to market' is the norm for companies trading in marketable instruments and commodities, a treatment that seems both logical and workable. It is one of the few occasions where it is justifiable to show assets in the balance sheet at anything other than historical cost. A failure to mark to market would not provide the shareholders of a trading company with a true and fair view of the profitability of their operations.

Despite the logic of the argument, the use of mark to market was a key factor in the collapse of Enron and the failure of financial reporting to show the true position. There were two problems here. First, that Enron was not just a trading company and the apparent 'profits' from trading were hiding problems in other parts of the business. Second, and even more significantly, the financial instruments issued and traded by Enron were unique and complex with, in many cases, no obvious market price in the public domain.

Enron therefore converted from 'mark to market' to 'mark to model' by creating complex computer models – for example to calculate the value of the right to sell bandwidth or energy packages several years ahead. The problem was that these models were constructed by the very people who originated the deals and no-one else could understand them. And in the Enron culture, where pay and survival were dependent upon short-term profits, the temptation to manipulate the model was very strong. Hindsight has shown their valuations to be highly optimistic.

It could be argued that the auditors should pick up such manipulation but in practice it is difficult when instruments are unique and complex. Even if auditors other than Andersen had been involved, this could still have gone undetected and such manipulations could still be happening in other complex trading companies.

IMPAIRMENT

The concept of impairment raises its head again in this context. All financial assets have to be reviewed for impairment in the same way as fixed assets and must be written down to economic value if necessary. Impairment might arise if the issuer of the instrument has financial difficulties, the market disappears or an investment is performing badly. As with the case of goodwill, the impairment tests – for example for shares in unquoted companies – may be highly subjective and those companies wishing to avoid write-downs may try either to avoid the test or to manipulate its results.

FROM ASSETS TO LIABILITIES

It is not only in the valuation of assets that there is complexity and potential for manipulation. The ascertainment of liabilities is also key to the correct calculation of profitability and to the statement of a true and fair view. This will be the subject of the next chapter.

8

The definition and ascertainment of liabilities

We have given extensive coverage of asset valuation, because it is such a key area for creative accounting and because of its connection with profit realization. This chapter concentrates on the other side of the balance sheet which is, in many cases, no less important. Analysts, particularly those that work for bankers and credit rating agencies, study both short- and long-term liabilities as critical factors in the determination of a company's financial stability. In particular the levels of debt are key to the assessment of gearing or leverage.

We need, therefore, to examine how liabilities are ascertained, defined and presented.

CAPITAL INSTRUMENTS

These are instruments used to raise capital for the company and the potential for creative accounting is strong, particularly for those companies with high debt levels. The key measure of gearing (or leverage) is the ratio of debt to equity, the usual conclusion being that companies with a high debt/equity ratio are rated as high risk. In some cases this may lead to problems of raising further finance and at worst, a loss of confidence in the company's future financial viability.

Therefore, there will be a strong desire for a company wishing to improve its credit rating to show the debt as low and the equity as high as possible. The removal of debt, or even better, its showing as equity, will be a highly attractive temptation for the company under pressure. To cope with this temptation an accounting standard – FRS 4 – has laid down rules that are intended to reduce creativity.

This standard requires disclosure of the detail of all financial instruments that have been used to raise capital for the business. It creates a definition of the difference between debt and equity which should transcend any legal definitions or internal/external labels. Capital instruments that contain an *obligation* to deliver a future economic benefit to the holders are classed as debt liabilities in the balance sheet; those that do not create such an obligation should be shown as part of shareholders funds.

One provision which allows some scope for creativity and which seems in some ways to be questionable, is that companies are allowed to deduct the direct costs of the issue of financial instruments from the liability, rather than taking them through the P&L in the year of issue. The inclusion of the word direct is perhaps to discourage the temptation to include allocations of other administrative costs that might conveniently be taken out of the P&L.

One possible area for manipulation here is the treatment of 'convertibles' – instruments which are issued as debt but which can be converted into equity at a specified later date, depending on the holders' choice. There is specific provision in the FRS to prevent conversion being assumed or anticipated; convertibles can only be shown as equity once conversion has taken place. There is also a requirement to show a split between debt which is convertible and that which is not. Knowing about the existence of convertibles is important to the analyst for the calculation of earnings per share on a 'fully diluted' basis – after assuming that all convertibles and other share options have been transferred into equity.

Case study 8.1

Cable and Wireless

In November 2002 Cable and Wireless announced a restructuring plan and revealed lease commitments relating to properties which had not previously been disclosed. The company had previously reported total property and other lease commitments of only £897 million. The company announced that it was reviewing its property portfolio and said in a note to investors:

> *This has identified that operating lease commitments on all properties are currently estimated to be some £1,800 million of which about half is due after more than five years.*

On 6 December, after a further revelation about a £1,500 million tax liability which had previously not been disclosed, the credit rating agency Moody's announced that it was downgrading Cable & Wireless's rating to junk status.

OFF-BALANCE-SHEET FINANCE

This is one of the biggest issues in creative accounting, one that was central to the Enron scandal. The aim is to move debt off the balance sheet and thus to hide the real borrowing levels. This presents a more stable financial position to the outside world – to the credit rating agencies, the banks and the analysts in the stock market.

The earliest and most widely practised method of achieving this aim was by means of leasing. As long ago as the 1960s it became very common for companies to convert agreements to lend money for specific assets – in practice hire purchase or credit sale agreements – into instruments that were technically and legally defined as leases. This was initially to avoid tax but became even more popular as highly geared companies realised that such agreements were an effective way of understating true debt levels. Whereas with hire purchase or bank borrowing the full asset and liability had to be shown, the leasing agreement avoided both and kept the entire transaction off the balance sheet. The only impact on reported results was the cost of leasing in the P&L; this might well amount to more than the depreciation and interest would have cost, but this did not seem to matter if the necessary manipulation was achieved.

Case study 8.2

Bradford City FC

It was reported on the 'Spiked' website (Banks, 2002) in September 2002, that Bradford City FC made use of a common device applied by many top football clubs. It is called 'off-balance-sheet third-party transfer funding'. This is 'football-speak' for sale and leaseback. Essentially they sold some of their players to a banking institution for a lump sum, and then rented the players back. Thus they kept the debt off the balance sheet, raised the cash to fund transfers and only needed to find the subsequent rent. This device also allows clubs to circumvent the Football League's strict rules on outstanding debts to other clubs.

Bradford City FC went into administration in May 2002.

So, as often happens with widespread practices of creative accounting, the regulatory authorities caught up by issuing an accounting standard SSAP 21. This was a clear illustration of 'substance over form' in practice. The reality of such deals had to be reflected in the accounts. All assets controlled by the business – whether or not owned – had to come onto the balance sheet. In the case of this type of quasi borrowing, defined as 'financial leases', the cost of the leased assets had to be shown in the balance sheet as an asset and the total lease commitment, including future cost of interest, as a liability on the other side. In effect the impact on the P&L and balance sheet was to recreate the position that would have existed if the asset had been bought and the money borrowed.

However, one issue of judgement and creativity remains. There are many different types of lease and some are not purely financial; for instance some leases may include other conditions – like the provision of maintenance or a commitment to replace the asset at a certain point. Therefore, the accounting standard allows for what are called 'operating leases' to be treated in the old way and kept entirely off balance sheet. This definition involves a judgement that there is substantially more to the deal than the provision of finance and this can involve fine distinctions about the balance of the risks and rewards of ownership. The creative accountant might decide to design or request a lease agreement that provides the necessary off-balance-sheet finance, while complying with the minimum further requirements to be defined as 'operating'.

Another issue around leasing is the well-known practice of sale and leaseback of properties. This practice provides funds for the company and, instead of leaving debt on the balance sheet, commits the company to a long-term lease which will be defined as 'operating' from an accounting point of view, and will, therefore, be kept off balance sheet. The ASB recently recognised this loophole by announcing that the present rules are inadequate, having been designed to deal with plant and equipment, rather than property leases. The IASB has also stated that it will seek to develop an international standard to deal with this issue.

The UK accounting standard which presently deals with these areas is FRS 5, which effectively provides the formal legitimisation of 'substance over form'. This is also the vehicle for dealing with other creative and ingenious attempts to keep debt off the balance sheet. An example of the sort of deal that was possible before FRS 5 is the pseudo sale. A company might sell goods to a finance company with an agreement to repurchase them at some agreed time in the future, with an extra payment for interest and holding costs. Money is received from the finance company and is booked as a sale rather than as a future liability. Thus there are two benefits: increased sales – yet another example to add to the methods of sales manipulation mentioned in Chapter 4 – and no record of the debt to be repaid in the future.

Of course the day of reckoning will come when the debt has to be repaid by repurchase of the goods and this will then have to be shown as a cost in the P&L. But creative accounting is usually about short-term manipulation, with the hope and expectation that further creativity will be able to hide the effect when the time comes. As with other previous examples, one act of creative accounting can often be the start of a slippery slope to greater levels of manipulation.

FRS 5 should have eliminated this kind of arrangement, though it is very much up to the judgement and watchfulness of the auditors. The standard refers to the underlying commercial logic of the transaction as being key and, as with the requirements for other judgements on revenue recognition, a crucial factor is where the real risks of ownership and the future economic benefits reside.

The following is an extract from the Powers report on Enron.

> *Many of the most significant transactions apparently were designed to accomplish favourable financial statements, not to achieve bona fide economic objectives or transfer risk … We believe that these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported.*
>
> *In virtually all of these transactions Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen … Enron's records show that Andersen billed $5.7 million for advice … above and beyond its regular audit fees.*
>
> *Disclosures … did not communicate the essence of the transactions completely and failed to convey the substance of what was going on between Enron and the partnerships.*
>
> Powers, 2002.

THE ENRON APPROACH

In recent times the most well publicised example of off-balance-sheet financing has been Enron. This company circumvented the US regulations on consolidating the debt of subsidiary companies by creating new 'Special Purpose Entities', or SPEs, in which nearly all the shares were held by organisations associated with Enron – for instance one or more of its investment banks. To comply with the US accounting standards, at least 3 per cent had to be held by other outside investors, who were in many cases company employees or associates. This structure meant that Enron was regarded as having no interest or ownership, even though the structures were set up by the company entirely for its own purposes.

Enron created an unbelievable 3,500 of these vehicles for the express purpose of taking their assets and debt off balance sheet and one estimate suggested that this took out $27 million of debt, compared to the $9.7 million declared. The mechanics of the transactions were that, having set up the company, Enron would then ask its banks to lend money to the new entity, taking Enron stock as collateral. It would then siphon off the cash by selling some of its assets to the new entity at a high price, thus achieving the extra benefit of a realised profit through the P&L. One factor which led to the bankruptcy was the fact that there were triggers requiring debt repayment if the Enron share price fell below a certain level, thus bringing the company down like a house of cards once these levels were reached.

We will discuss in the final chapter the extent to which Enron could happen here and one argument against is the statement of specific guidelines in FRS 5. The standard requires the accountants and auditors to identify the parties who benefit from the transaction and to look at the real impact of the arrangement as a whole. There is the clearest possible justification of 'substance over form' by the requirement that 'financial statements should report the substance of the transactions … all its aspects and implications should be identified and greater weight given to those more likely to have a commercial effect'. Moreover, the standard requires that the effect of a series of transactions be considered together rather than each in isolation.

The SPEs should not have passed UK scrutiny for another reason. FRS 5 defines a 'quasi-subsidiary' as a business which, while not falling within the normal definition of a subsidiary, is controlled by the reporting company. The standard requires that such entities be treated for reporting purposes like normal subsidiaries, with their profits, assets and liabilities aggregated with the group accounts. Another standard – FRS 8 – makes reference to 'related parties' and requires disclosure of any significant arrangement between organisations, where one has direct or indirect control over the other or they are subject to common control. It is highly likely that most or all the Enron SPEs would have fallen under this definition, though it remains to be seen whether UK auditors would have enforced the standards under the circumstances prevailing at Enron.

Case study 8.3

PricewaterhouseCoopers

In November 2002 PwC, one of the remaining big four firms left after the demise of Andersen, was still advertising on its Channel Islands website, devices to keep financing off balance sheet. It said:

> *You will not have to consolidate these entries or restate prior year financials, if by the effective date you sell the entities, relinquish control, or have a plan in place to cede control within one year. If … your performance measures … are negatively affected, work with your investor relations advisers to come clean and soften the blow to shareholders.*

PROVISIONS AND CONTINGENT LIABILITIES

We touched upon the issue of liability recognition when covering cost ascertainment in Chapters 3 and 5. A key judgement area is when to recognise a cost and how much to include when the invoice has not yet been received, via the creation of an accrual. A further and connected judgement area is the creation of *provisions* – the estimates that have to be made when the outcome is more uncertain. This can provide a field day for those who feel the need to be creative.

A provision is a liability that is uncertain in terms of its timing and amount but is, as far as can be ascertained, likely to occur to some extent. This differs from another concept which is important for disclosure purposes – the *contingent liability*. A contingent liability depends on a particular event happening before the amount has to be paid; typical examples would be a guarantee for a bank loan which requires another party to default before it becomes due, or litigation that is awaiting a court decision. A provision creates a liability in the balance sheet and a cost in the P&L, whereas a contingent liability only requires disclosure in the notes to the accounts.

Creative accounting for liabilities can occur in two ways. One is for the company intentionally to fail to make a provision for a known liability, thus postponing the cost in the P&L, and removing any mention in the balance sheet. This can occur either through complete omission or by the false pretence that a known liability is still contingent on the happening of a future event. Both of these ploys might be adopted by a company that wishes to overstate profits in the short term.

A more commonly quoted example of creativity – perhaps because it is easier to achieve and more visible to the external observer – is the creation of provisions earlier than would normally be required. This is a mechanism for the well-known practice of 'earnings smoothing' – maybe taking the hit early if it looks like being a good year, and using the provision in future years when results may not be so favourable. Newly appointed chief executives are well known for making such provisions soon after appointment, to get all the bad news out of the way while their predecessor can be blamed!

To guard against too much abuse, there are rules concerning such provisions. The provision can only be made when the liability exists as a result of an event that has already occurred and can be reasonably estimated. This leads to grey areas when, for example, restructuring costs are involved. If the decision to restructure has been made but the timing is in the future, should that be recognised as a liability during the period of the decision? The answer is that such practices should be followed if the company clearly has an obligation and is committed to carrying it out.

One possible abuse for a company wishing to reduce earnings would be to declare that a decision to restructure has been taken and make an estimate of the amount as a provision, only to reverse that decision in the following period, releasing the provision back to enhance profits. At the other end of the spectrum the financial director whose earnings smoothing strategy requires higher profits in the current period, might just keep quiet about restructuring until next year. In such circumstances it has been known for the board meeting minutes of decisions to be amended to avoid the auditors' scrutiny!

Creativity regarding contingent liabilities concerns their disclosure rather than their accounting. Again the possibility of creativity by omission exists; it can be hard for an auditor to discover the extent of a company's contingent liabilities without their cooperation, and the existence of such liabilities can be crucial information for the analyst who wishes to assess all potential risks.

THE COMPLEXITIES OF BUSINESS COMBINATIONS

So far we have simplified by looking at single company situations, where the assets and liabilities clearly belong to one legal entity. The reality of all the issues covered so far in this book is quite different and far more complex when several businesses are working together, or one company controls a number of others. This topic is the subject of the next chapter.

9

Group accounts and business combinations

BUSINESS COMBINATIONS AND CREATIVITY

In Chapter 6 we touched upon the issue of acquisitions, in particular the impact on the balance sheet of accounting for the excess of the price paid over asset value – the goodwill. Acquisitions are a fruitful area for creative accounting because the numbers are so large and the potential for manipulation so great. If a company is making regular acquisitions it can often be difficult for the analyst to find out what is happening to the core business – indeed there are cases where one suspects that this may be one of the reasons behind the strategy.

However, acquisitions are not the only form of business combination that has accounting implications and opportunities for creativity. Our implied assumption in Chapter 6 was that the acquiring company takes over the whole business and therefore brings in 100 per cent of the acquired assets into its balance sheet. In practice every deal is not like that; a percentage of shareholding is often left with previous shareholders and in some cases this can be close to or even more than 50 per cent. In these cases special accounting issues apply.

There will also be cases where the combination of two businesses is more of a merger than an acquisition, for instance when the two companies are approximately the same size. Again different accounting principles are applied here and the impact on reported results can be significant.

This topic is large and extremely complex; we can do no more than touch upon some of the major areas where there is potential for creativity.

ACQUISITION OR MERGER

The significance of this distinction is that the classification of a business combination as a merger rather than an acquisition, avoids the need to write off goodwill, and all the problems of valuation mentioned in Chapter 6. It is, therefore, not surprising that some company top managers like to classify their deals in this way if at all possible.

Accounting for a merger is completely different from an acquisition. Rather than taking the assets into the acquiring company's balance sheet, the balance sheet is completely redrawn with the assets of both businesses and there is a restatement of equity in the combined entity. The detail of this is less important than the impact for top management – no embarrassing goodwill write-offs, no record in the balance sheet of how much was paid, no impact on earnings per share.

The distinction between a merger and an acquisition is enshrined in FRS 6 but inevitably with such a fine distinction there is scope for judgement and creativity. This standard makes it difficult for a deal to be classed as a merger, perhaps because those who drafted it knew how attractive it would be for management with creative tendencies.

The definition of a merger in FRS 6 is:

> *a business combination that results in the creation of a new reporting entity formed from the combining parties, in which the shareholders … come together … in a mutual sharing of the risks and benefits of the combined entity, and in which no party … obtains control over the other, or is otherwise seen to be dominant …*

For the status as a merger to be accepted, there are a number of tests and, while they are relatively specific and stringent, they are also highly judgemental. A brief overview of these tests is as follows:

- No portrayal of one party as acquirer.
- All parties included in the management structure.
- Relative equality of size, the guideline is no more than 60 per cent to one party.
- Mainly an equity deal.
- Future rewards for all parties based on combined performance.

However, the key weakness in all this, and one which is obviously there to be exploited, is that the judgement has to be made *at the time of the acquisition*. It is impossible for anyone to know how the acquisition is to pan out and the reality 12 months down the line can be very different from the intentions at the time the judgement was made. And then it is too late to reverse the accounting.

MINORITY HOLDINGS

Where companies have subsidiaries which are not 100 per cent owned, there may be attractions to the holding company in not showing the full financial position of the subsidiary in the consolidated accounts. The normal principle in the UK and internationally is that where a controlling interest is held – prima facie over 50 per cent – that subsidiary's full assets and liabilities will be shown in group accounts with the minority holding shown as a liability. Similarly, the full sales and profits will be shown in the P&L, with a reduction to cover the minority profit share.

However, there may be particular occasions when the holding company prefers not to consolidate, particularly if there are losses or if the subsidiary has liabilities that it would prefer to keep off balance sheet.

Because of the potential for creativity here it is important that there is a workable and effective definition of 'subsidiary'. The UK rules use the term 'subsidiary undertaking' and make a definition which is to some extent subjective. The following extract gives a flavour:

the ability of an undertaking to direct the financial and operating policies … with a view to gaining economic benefits from its activities.

Such a subjective provision can inevitably lead to creative accounting for the company that wishes to keep its subsidiaries away from the consolidated accounts. In fact there are specified conditions that need to be fulfilled but a quick look at them reveals the potential for judgement and manipulation. A subsidiary can be kept separate if:

- its activities are different;
- the parent's long-term rights are restricted;
- it is being held for resale;
- obtaining the information would cause delay;
- it is immaterial to the total results.

This is yet another indication that, whether a prescriptive or a judgemental approach to regulation is used, the potential for creative accounting will still be there.

Case study 9.1

International Accounting Standards Board

In December 2002 the International Accounting Standards Board announced its recommendation that, in future, companies will no longer be able to, from an accounting point of view, treat business combinations as mergers. Although only about 5 per cent of combinations have been treated in this way, there has been concern about the extent to which such treatments have avoided the goodwill write-offs that other companies have had to suffer. High profile and large-scale examples of merger accounting have been HBOS and BP Amoco.

At the same time the IASB announced that it was following the lead of the US authorities by abolishing the practice of amortizing goodwill, which has been criticized and largely ignored by many analysts. Instead the acquired goodwill will be valued each year and will only be written down if impairment has taken place.

The intention is that these new rules will, like other international standards, be applied throughout the European Union by 2005.

ASSOCIATED COMPANIES

In practice many companies hold shares in other companies and the holding is less than 50 per cent. Sometimes this can be a straightforward arms-length investment with the aim of receiving dividends and capital growth; sometimes it can be an association, maybe with a supplier or other strategic partner. Sometimes, there can be close control of the company even though there is not a majority shareholding – for example a partnership venture run by the company concerned. The range of potentially different association arrangements makes the accounting difficult and subjective, so there are some potential openings for creativity.

Under traditional accounting principles, investments of this kind would be held in the balance sheet at cost, with any dividends showing as income received. There would be no upward valuation and profits would only be taken if and when the investment is realised. As early as the 1960s this principle was challenged and companies began to do things differently. Their argument was that, where the investment was more than arms length and involved some kind of association, the traditional method was understating value and failing to provide a true and fair view. Using the principle of 'substance over form' it was argued that the legalities of ownership were less important than the true relationship. The logic of this was compelling but the accounting proved to be complex and the judgements subjective.

The process carried out to produce a better reflection of the realities of such associations is known as 'equity accounting' and it involves a partial consolidation of what are called 'associated companies'. Instead of dividend, the P&L reflects the relevant proportion of the profits made by the associate, and the balance sheet shows it as an 'investment in associated companies', the value of which increases in line with the share of retained profits. It is not difficult to see the attraction of this method for the company wishing to increase its earnings, particularly in circumstances where it holds a minority stake in a business with substantial earnings but little or no dividend income.

This practice of equity accounting was recognized by a special accounting standard in 1971 and is now covered by FRS 9. It remains an area of complexity and subjectivity, because it is difficult to produce black and white distinctions between the different types of minority arrangement. This situation has become even more complex and judgemental in the past decade as joint ventures and strategic alliances have increased in number and complexity. As we will see below, the treatment of joint ventures is now an issue worthy of special attention.

Creative accounting in this area can work two ways. First, the company wishing to inflate earnings may seek to treat investments in profitable companies by the equity method, even though the facts do not really justify that treatment. Just as likely is the reverse situation – avoiding the equity method for loss-making associates, to keep a share of such losses off the P&L.

Whichever way the manipulation is attempted, certain criteria have to be met and, as with mergers and subsidiaries, these are subjective and capable of manipulation. The definition of an associated company to justify the equity method is as follows:

> *an entity … in which another entity … has a participating interest and over whose operating and financial policies the investor exercises a significant influence.*

Like many such definitions in accounting standards, it is an invitation to the creative accountant. What is a 'participating interest' and how much influence is 'significant'? What if the influence is over operations and not finances, or vice versa? The usual interpretation of 'participating interest' – confirmed by FRS 9 – is long-term investment for the purpose of securing a contribution to the company's activities. Such a definition is similar to that of the Companies Act and this legislation introduced the presumption that a 20 per cent holding or more would normally involve a participating interest. The other indications are that the holding is long-term and was not bought initially for the purpose of resale, conditions which clearly depend upon assurances by the company concerned.

JOINT VENTURES

As joint ventures have become more widespread, their accounting has become more important. In many cases they represent major investments and often they involve high risk. The profits or losses have to be properly accounted for in the books of the partners and, for publicly quoted companies, there may be a desire to use accounting methods that take in the profits but avoid the losses.

A special accounting standard – FRS 9 – had to be developed to deal with the issues involved. Again definition is important and this standard makes a fine but important distinction between a joint venture (JV) and a joint arrangement (JANE – standing for 'joint arrangement that is not an entity'). A joint venture is:

> *an entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by … one or more other venturers under a contractual arrangement.*

To be classified as a joint venture the deal must be one where none of the parties can control the entity on their own and where the key decisions require each venturer's consent. To fall within this definition there must also be a clearly separate entity carrying on a separate business, which is not part of or dependent upon one of the parties to the venture. A 50/50 shareholding would be evidence of a joint venture, as would a shareholders' agreement that stipulated joint control.

However, as with other UK accounting standards, 'substance over form' dictates that it is the reality of the venture's operations rather than the legal structure that matters and, though this principle makes sense, it does open the doors for judgement and creativity. In particular it puts a major onus on the auditors to check out suspect definitions and look behind the legal status and the assurances of management.

In accounting terms a JV is treated in much the same way as an associated company, with a proportion of the results being brought into the group accounts. There is, however, a special requirement which only applies to JVs; a share of the assets and liabilities must be shown in the balance sheet and a share of the sales turnover should be shown in the notes to the accounts. The share of assets and liabilities can be netted off as separate headings – 'interest in net assets' and 'interest in net liabilities' of joint ventures – and this means that this is yet another way in which the creative accountant might take debt off balance sheet. By creating a special entity which is defined as a JV and raising debt through it, the amount would be hidden from the normal debt heading in the balance sheet and would only be visible to the analyst who explores the detailed split of the JV's net liabilities.

JOINT ARRANGEMENTS

The significance of classifying an arrangement as a JANE is that it is only accounted for by the recording of the specific profits, cash flows and assets that occur as a result of the arrangement. Thus, there is no question of including a share of total profits or, more significantly, any proportional valuation of the venture in the balance sheet. The definition to distinguish a JANE from a JV is as follows:

> *A contractual arrangement under which the participants engage in joint activities that do not create an entity because it would not be carrying a trade or business of its own.*
>
> FRS 9.

The difficulty of understanding what such a definition actually means provides an indication of the problems accountants and auditors have in applying it in practice. The creation of the JANE arose in response to the concerns of those who drafted FRS 9 that in some industrial sectors – for instance oil exploration – joint arrangements were being accounted for by the equity method when limited influence was exercised by the party concerned. For instance an oil company might be taking a share of profits for an exploration venture clearly operated and controlled by the other party.

The definition of a JANE was a compromise that has led to yet more judgement and creativity. The normal feature of a JANE is that there is no separate structure as a legal entity. Also, for an arrangement to be classified as a JANE it has to be shown that the parties have arrangements for benefits to be received in kind – rather than merely sharing the profits or losses – and that the share of profits has a link to the resources put in.

It is not worth going into more detail – of which there is plenty – about this complex issue. What has been said already is enough to show that it is a complex mess that causes confusion and debate. In such cases creative accounting can extend not only to self-serving interpretations of these fine definitions and distinctions, but also to the legal structures that are set up. Where the financial results are likely to have a big impact on the accounts of the parties involved, it may be critical to have evidence of a structure that complies with the required definition.

This may also change over time in interesting ways. When a venture is first set up there is no evidence of how it will work, other than the legal documents. Over time the realities of operation may prove to be very different and FRS 9 allows for the accounting treatment to be changed if the accountants or auditors believe this to be necessary. It is also possible for the company management to want this for its own reasons. If the venture was set up as a JV – allowing profits to be consolidated – but then turns out to be loss making, the management may be very happy for it to be reclassified as a JANE, restricting the losses to its own profit and cash-flow impact.

THE CONCLUSION

So far the book has covered the main areas of accounting creativity and this may encourage the reader to ask a number of questions:

- With all this complexity and potential for creativity, what confidence can we have in the accounts of any publicly quoted company?
- Is the received wisdom that 'Enron could not happen here' really justified?
- How far has the UK accounting profession developed a valid conceptual framework which provides the necessary controls?
- Is the answer to 2 + 2 always likely to be, 'what would you like the answer to be'?

In the tenth and final chapter we will address all these issues.

10

The present and the future

THE POST-ENRON SITUATION

At the time of writing we are in an interesting phase. It is now over a year since the Enron saga entered the public domain and there were severe shock waves for those trusting souls who believed that every set of accounts presented to them could be relied upon. Then in quick succession there were other high profile examples of creative accounting, followed by indictments for fraud, bankruptcies and share price collapses.

At first it seemed to be a US phenomenon and mainly confined to young thrusting companies in high tech sectors, almost an extension of the false hype that surrounded the dot-com boom. Then came the reality that it was not just the new upstarts; companies with long histories and venerable names began to announce that their accounts were having to be restated – Rank Xerox, Bristol Myers Squibb, AOL Time Warner. In July 2002 the US Administration brought in the Sarbanes-Oxley Act, to force all CEOs of major companies to make a declaration that their accounts were properly completed and truly reflected the company's financial position.

In the US, the nature of accounting has become a major public issue and the extent of creativity and manipulation has caused surprise and concern. President Bush spoke out against those who are 'cooking the books, shading the truth and breaking our laws'. In November 2002 Harvey Pitt, Chairman of the SEC – the body responsible for enforcing the Sarbanes-Oxley Act – resigned and soon after his choice of chairman of the 'Public Company Accounting Oversight Board' which will oversee implementation, William Webster, resigned before he had even started the job. A total of 250 companies will have to restate their accounts in 2002, compared with only 92 in 1991 and 3 in 1981.

In the UK we sat back at first, thinking that this was a US phenomenon, rejoicing in the fact that we have a better system of regulation. The argument was that we use general principles rather than detailed rules; we rely on judgement and the spirit, rather than the letter, of the law. Yet now as we scan the financial press we discover accounting irregularities and 'black holes' in a number of UK companies. Maybe nothing so major and high profile as Enron so far but clear examples of poor accounting and control at public companies like Amey, MyTravel and SFI.

Case study 10.1

Xerox

On 28 June 2002 equipment maker Xerox revealed in a press release that it had become the latest company to be involved in an accounting scandal. It revealed that it had inflated revenue by some $1.9 billion over the past five years. The company said that it would publish revised accounts, showing a restatement of financial results from 1997 to 2001.

'Xerox today closes a difficult chapter in the company's history', said Anne M. Mulcahy, chairman and CEO. 'We have resolved the company's accounting issues with the SEC and completed the restatement. And, we are firm in our resolve to ensure the highest integrity of the company's financial reporting.'

A DIFFERENT APPROACH TO ANALYSIS

One implication of these developments is that shareholders and analysts are unlikely to be so reliant on reported figures and so trusting of audited accounts. The trend of many of the better analysts in recent years to focus on *cash flow* as much as profit is likely to continue, the argument being that cash-flow statements are less subject to creativity. The frequently advocated way of spotting creative accounting – looking at cash-flow generation compared to profits – has received some publicity, with the suggestion that the lack of cash-flow generation should have alerted analysts to Enron's problems. However, even this approach was questioned when in June 2002 it was announced that the SEC was concerned about the way in which cash-flow statements had also been manipulated by revenue swapping deals, including the revenue in cash flow from operating activities and the cost as an 'investment outflow'.

It is also likely that analysts will take a much more careful look at accounting policies and ask more searching questions about the role and objectivity of the auditors. The publicity will make the key areas of creative accounting in particular sectors more widely known and directors will become more cautious in their approach to accounting. In particular non-executive directors, frightened by the consequences for those who were in that position at Enron, will be more likely to ask the right questions and insist upon the right assurances.

Case study 10.2

European Union

In November 2002 the European Union announced proposals for new tough disclosure rules to prevent scandals like Enron and Worldcom happening on this side of the Atlantic. This could lead to major change in several countries not renowned for their corporate governance – France, Germany, Italy and Spain.

If accepted there will need to be far greater disclosure of financial information – for instance directors' pay – and the appointment of independent directors to audit committees. The Brussels regulators are to ask all European companies to comply and threaten binding legislation if companies fail to do so.

Though this only brings other European countries into line with the UK, it is a significant step forward and a clear response to recent revelations.

COULD ENRON HAPPEN HERE?

We stated in Chapter 8 that the received wisdom following Enron, Worldcom and other recent scandals in the US, has been that 'it couldn't happen here'. Because we favour general principles over detailed rules and because we claim to have a stronger conceptual and regulatory framework – in particular the principle of substance over form – it should not be possible for companies to do what Enron did, or for the auditors to fail to detect it. This is dangerous and complacent. In reality, as should have been evident at several stages of this book, the thinking around UK accounting is in some disarray. The 1999 ASB paper 'Statement of Principles for Financial Reporting' questioned the traditional fundamental principles of prudence and consistency and this paper received rigorous criticism and challenge, notably from one of the big four firms – Ernst & Young. It is true that the UK's more judgemental – rather than legalistic – approach gives us some advantages over the US, but there are still weaknesses in the UK at the time of writing. The traditional principles of accounting have been questioned by the ASB but we are a long way from achieving agreement about a new conceptual framework to take their place. In particular the attempts to apply 'fair value' accounting have not yet proved that it provides a better framework for control than the traditional historical cost principle.

A further point is that Enron would probably have happened here because, whatever the rules and no matter how wide their acceptance, a determined management that is bent on manipulating the results by creative accounting will usually be able to do so in the short term, whatever the accounting regulations. What made the Enron case so concerning was that the auditors even appeared to be conspiring with management to find new ways to be creative within the accounting regulations. How can we be sure that Andersen in the UK would not have cooperated in a similar way?

Such practices will hopefully now become less likely for a while because of the increased public attention and the now known consequences of being found out; but creative accounting will never be eliminated entirely. There will always be that fine line between 'acceptable' earnings smoothing and outright manipulation which some will be tempted to cross.

There is one further factor that would have allowed Enron to get away with much of its deception, even within the UK regulatory system. This is the fact that Enron is a highly complex business, involved in trading activities that stretch the capacity and knowledge base of conventional accounting and auditing practice. The complexities of energy trading are unlikely to be familiar to the average auditor, who will rely on company management to explain and make key decisions about their accounting treatment. Enron is but one example of the increasing trends to greater complexity in modern businesses which increase the temptations and, in the short term, decrease the chances of being found out.

It is, therefore, impossible to be sure whether or not new Enrons are around at the current time, waiting to be discovered. This is quite possible, because while there is pressure for short-term results and while there is scope for creative accounting, there are always likely to be temptations. The responsibility lies in two areas: with investors who must be vigilant and ask the right questions, and with the directors of companies who must take full responsibility for the truth and fairness of the information they produce. In the end the responsibility for good accounting must rest clearly and unequivocally with them.

Appendices

Appendix 1

UK accounting bodies represented on the Financial Reporting Council (FRC)

- Institute of Chartered Accountants in England and Wales.
- Chartered Institute of Management Accountants.
- Institute of Chartered Accountants of Scotland.
- Institute of Chartered Accountants of Ireland.
- Chartered Association of Certified Accountants.
- Chartered Institute of Public Finance and Accountancy.

Appendix 2

UK accounting standards December 2002

FRS

1 Cash-flow statements.
2 Accounting for subsidiary undertakings.
3 Reporting financial performance.
4 Capital instruments.
5 Reporting the substance of transactions.
6 Acquisitions and mergers.
7 Fair values in acquisition accounting.
8 Related party disclosures.
9 Associates and joint ventures.
10 Goodwill and intangible assets.
11 Impairment of fixed assets and goodwill.
12 Provisions, contingent liabilities and contingent assets.
13 Derivatives and other financial instruments: disclosures.
14 Earnings per share.
15 Tangible fixed assets.
16 Current tax.
17 Retirement benefits.
18 Accounting policies.
19 Deferred tax.

SSAP

4 Government grants.
5 Value added tax.
9 Stocks and long-term contracts.
13 Research and development.
17 Post-balance-sheet events.
19 Investment properties.

20 Foreign currency translation.

21 Leases and hire purchase contracts.

24 Pension costs.

25 Segmental reporting.

Appendix 3

International accounting standards

IAS

1 Presentation of financial statements.

2 Inventories.

7 Cash-flow statements.

8 Net profit or loss for the period, fundamental errors and changes in accounting.

10 Events after the balance sheet date.

11 Construction contracts.

12 Income taxes.

14 Segment reporting.

15 Information reflecting the effects of changing prices.

16 Property, plant and equipment.

17 Leases.

18 Revenue.

19 Employee benefits.

20 Accounting for government grants and disclosure of government assistance.

21 The effects of changes in foreign exchange rates.

22 Business combinations.

23 Borrowing costs.

24 Related party disclosures.

26 Accounting and reporting by retirement benefit plans.

27 Consolidated financial statements.

28 Investments in associates.

29 Financial reporting in hyperinflationary economies.

30 Disclosures in the financial statements of banks and similar financial institutions.

31 Financial reporting of interests in joint ventures.

32 Financial instruments: disclosure and presentation.

33 Earnings per share.

34 Interim financial reporting.

35 Discontinuing operations.

36 Impairment of assets.

37 Provisions, contingent liabilities and contingent assets.

38 Intangible assets.

39 Financial instruments, recognition and measurement.

40 Investment property.

41 Agriculture.

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