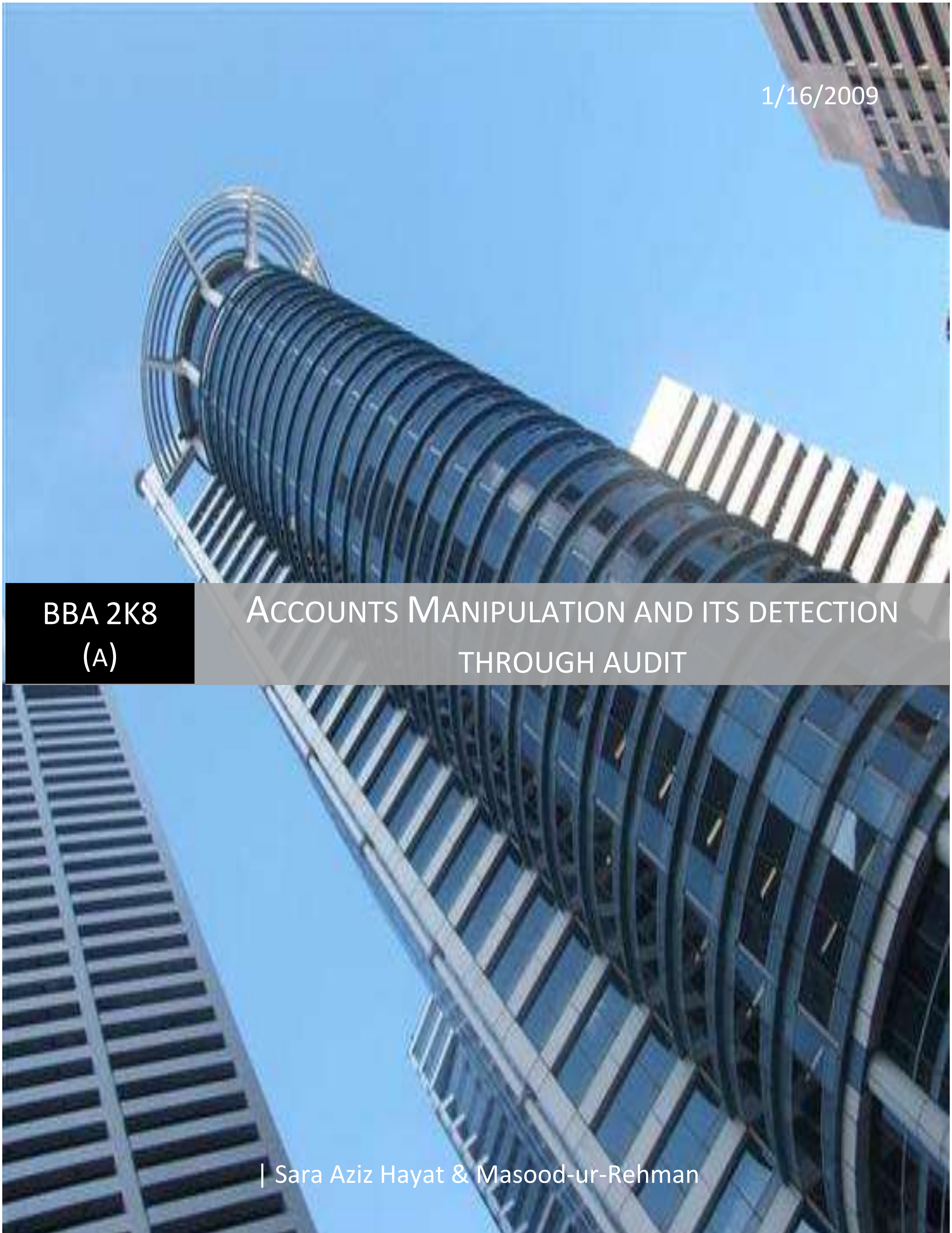

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ACCOUNTS MANIPULATION AND ITS DETECTION THROUGH AUDIT

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Abstract

This research paper examines different aspects of accounting manipulation practiced by some companies. Many of such practices are culpable under the law. However, companies use various forms of accounting subterfuge to deceive shareholders and the public.

The paper indicates broadly the various kinds of fraud in this connection. An attempt is made in this paper to indicate various laws framed to penalize accounting fraud. It also gives an example of major fraud committed in this context by one of the world's largest company, ENRON.

The report ends by giving certain recommendations as good practices to prevent accounting fraud.

Acronyms

CTM	Continuous Transaction Monitoring
EM	Earnings Management
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principals
LJM	Lea, Jeffery, Michael
SEC	Securities and Exchange Commission
SPE	Special Purpose Entities

Introduction

Firms manipulate their accounts (cooking the books) to make their financial statements appear better than they actually are, to keep their stockholders happy, attract new investors, meet budgets and most importantly, to earn bonuses for their executives. Executive bonuses are earned if a certain level of earnings is produced. This makes it tempting for management to show more earnings than the actual. Another reason why management bloats its earnings is to keep a struggling firm afloat until it can turn a true profit.

Since investors are attracted by rising stock prices of public firms, the importance of how their financial statements appear is crucial. Wall Street analysts use the firm's financial reports to make recommendations to the public. Thus companies receive more investment from the public if analysts give them good reports. Those people who buy stock, need to be assured that the value of their investment will soar. Such confidence is created by good profit per share ratio as projected in stock analysis

In the following sections we will look into all the different ways in which accounts are manipulated including highlighting ways how they may be detected. Later we will discuss the ENRON case – to explain how the fraud was initiated and how it was exposed.

Literature Review

Stolowy and Bretan (2003) have shown various aspects of account manipulation like earnings management, income smoothing, big bath accounting, creative accounting and window dressing. They have proposed a conceptual framework explaining the main drive of firms to manipulate accounts. Firms commit various types accounting fraud to raise the value of the firm's stocks and thus divert through subterfuge funds of investors into their assets.

Dye (1998) and Schipper (1989) have explained how pressure form different interested parties in a firm which includes existing or potential stockholders as well as present or future bondholder, exert pressure on managers of firms to manipulate accounts. In this way the interested groups abuse their position to make unlawful gain through fraud.

Patel (2008) suggests that success and monetary incentives can blind people to behave in an underhand manner, ignoring rules, standards and integrity ordained by law. There must be continuous vigilance and severe punishment for errant behavior to discourage account fraud.

Dechow and Skinner (2000) are of the view that the generally accepted accounting principles (GAAP) allows space for a degree of interpretation. To be legal, the interpretation must be kept within the permitted levels stated by the standards.

Methodology

The main source of information for preparing this research paper was obtained from the work of Herve Stolowy and Gaetan Breton in their path breaking paper “A Review of Research on Accounts Manipulation,” and Fraud Detection by Hitesh Patel. Several financial journals found on the internet were also consulted while conducting research for this paper.

Different methods were followed to deduce information about the different types of manipulations that are discussed. These methods are presented in table form and is attached as annexure to this report.

Accounts Manipulation

There are several ways through which accounts are manipulated. Accounts manipulation can broadly be classified under the following headings; (1) earnings management, (2) income smoothing, (3) big bath accounting, (4) creative accounting and (5) window dressing. **Figure 1** presents a framework for depicting the practice of accounts manipulation and **Figure 2** shows the principles behind accounts manipulation.

1. Earnings Management (EM)

Earnings management is a strategy used by the management of a company to intentionally manipulate its earnings so that its figures match the pre-determined earnings target. This practice is carried out for the purpose of income smoothing (which we discuss later). Companies try to keep their earnings over the years relatively stable by either adding or removing cash from reserve accounts, also called the 'cookie jar' accounts. According to Kellog and Kellog (5:1991)[1], EM is motivated by two factors; to increase the market value of the firm and to attract new investors. **Table 1** shows a list of objectives of earnings management in its different contexts.

Dye (5:1988)[2], stated that EM originated from the fact that there existed a gap in the information between managers and shareholders. Dye also highlights two points in his depiction. First, he states that manipulation is done to increase the remunerations of the executives accruing from the shareholders. Secondly, even the shareholders themselves benefit in the market if the firm produces good figures as the value of their shares increases. This produces an external demand for EM as wealth is transferred from new shareholders to old ones (Schipper, 1989)[3].

2. Income Smoothing

Income smoothing is to project false earnings which do not exist. The main aim of income smoothing is to produce a steadily growing stream of fictitious profits. It mainly redistributes income statement credits and charges among different periods. Its object is to moderate income variability over the years by shifting income from good years to bad years. Income variability is also modified by shifting losses or expenses from one period to another. Therefore for income smoothing to work, it's very important for the firm to make large profits so as to regulate the flow as and when necessary. **Table 2** depicts some of the ways in which income smoothing is done. **Table 3** shows a list of motivations for income smoothing.

Detection of Income smoothing through audit;

There are several ways that are used to detect income smoothing. Normally this is done by investigating the basis of inflows (smoothing objects), historic trends (the number of periods covered), range of variation in incomes or large income distortions (smoothing variables and dimensions).

The smoothing objects;

The smoothing objects are numbers that are considered a target of smoothing attempts. **Table 4** shows a list of smoothing objects.

The number of periods covered;

For empirical studies on income smoothing, an optimal number of periods involved in the investigation needs to be decided. Copeland (1989) believes that income smoothing to be successful needs to cover a long period because the length of period influences the result of the study.

Smoothing Variables;

Smoothing instruments are variables used by managers to smoothen particular accounting figures (Kamin and Ronen 1978). Imhoff (25:1981) says that another method to investigate income smoothing is to select variables that are both observable and capable of being influenced by management and to observe their effects on earnings. **Table 5** shows examples of some smoothing variables.

Smoothing Dimensions;

Smoothing dimensions are the various methods through which smoothing is supposedly accomplished. The methods are summarized in **Figure 3.**

3. Big Bath Accounting

Big bath accounting is an illegal strategy adopted by management to manipulate a company's income statement to make poor results look worse. It is done in a bad year to artificially enhance next year's earnings and even ordinary performance look better. The apparent rise in earnings results in a large bonus for the executives. It also reaffirms a shareholder's trust in the company.

4. Creative Accounting

Creative accounting is the manipulation of financial numbers, usually within the framework of the law and accounting standards. Its aim is to either inflate profits or to reduce profits in a good year so as to “smoothen” them later. Assets and liabilities may also be manipulated to project false picture of a firm’s position.

Detection of creative accounting through audit

This section reviews the various techniques for detecting accounting frauds. Briefly creative accounting tricks include off balance sheet accounting, manipulation of expenses and manipulation of non-recurring expenses and pensions.

Off balance sheet accounting;

By off-balance sheet accounting, management can exclude certain assets and liabilities from the balance sheet. It is often used to make the company is debt appear far lesser then it actually does. Off balance sheet accounting may move debt to a newly created company. This maneuver was adopted by ENRON. Such false companies are called Special Purpose Entities.

Manipulation of Expenses;

Exaggerating a company’s expenses may not be the way to enhance the appearance of earnings. It all depends on when those earnings are enhanced. The remuneration a manager gets is based on whether they’ve met certain earnings goals. In another instance, the company might even delay recognizing expense. The net result is that the profit and loss within a specific period is displayed wrongly and thereby creating a wrong assessment of performance thereby misleading investors and shareholders.

Non-recurring expenses manipulation;

This category of expenses is kept for things that occur only once in order to prevent it from affecting regular operating expenses. Companies abuse this category of expense by over-budgeting for a non-recurring expense in order to move excess money as earnings. This is what companies do in order to increase earnings per share.

5. Window-Dressing

Window-dressing may be defined as the deceptive practice of using accounting tricks to make the balance sheet and income statement of a company appear better than it actually is. Another way to look at it would be to define it as the deceptive practice of mutual funds in which recently weak stocks are sold and recently strong stocks are bought just before the fund's holdings are made public. The aim is to give the appearance that the company has been holding good stocks all along.

Since performance reports and the list of holdings in a mutual fund are usually sent to clients every quarter, the fund manager will window-dress the reports by selling stocks with losses and buy profiting stocks at the end of the quarter. These securities are reported as part of the fund's holdings, thus concealing the losses incurred in the "intervening period.

Preventing Fraud

1. The Sarbanes-Oxley Act

In 2002, George Bush passed the Sarbanes-Oxley act to "re-establish investor confidence in the integrity of corporate disclosures and financial reporting."[1] Under the act, it is mandatory for all public companies to submit both quarterly and annual assessments of the effectiveness of their internal financial auditing reports and control mechanisms to the Securities and Exchange Commission[2] of the US. These reports are then checked by external auditors who evaluate whether the internal control reports of the management are accurate and robust.

According to this law the requirement is for the company's principal executive officer and principal financial officer to certify that in the report is true and that all relevant information has been disclosed. There are also other important US regulatory organizations like the SEC, FASB and GAAP that are concerned with the act.

2. Continuous Transaction Monitoring for Fraud Detection:

The early identification of signs of fraud and other breaches can prevent serious damage. Continuous transaction monitoring is based on monitoring transactional activity of a company. Analysis of invoices and payments could be timed to take place weekly, right before the payment sequence is completed. Since the time when the funds are just about to be paid poses the greatest risk for accounts to be manipulated, monitoring of this time period is crucial.

CTM testing involves the detection of change/change-back data, which goes undetected during conventional audit programs. Similarly, tests may also be executed across manual journal entries just before the finalization of the financial statements. Anomalous adjustments can be noted and their rationale investigated to ensure that the facts stated in the financial statements are correct.

There are a few choice areas from which CTM can be started. One of these is the employee expense account. Here the transaction volume is relatively low so its testing is straightforward and simple.

3. Data Mining

Data mining is an efficient mechanism to both detect and deter fraud. According to the Sarbanes-Oxley Act, it is of paramount importance that public companies should implement anti-fraud mechanisms. The purpose of these mechanisms is to detect fraud, and thus, deter future fraud. Many companies however, do not take advantage of the large amounts of electronic data stored on their servers, which contains the relevant "smoking gun" to reveal fraud that may be occurring.

Every organization contains a minimum amount of electronic data regarding its financial transactions. They are kept in the General Ledger Transactions and relate to customer, vendor and employee accounts. This data can reveal fraud that otherwise may not be detected. Investigating this area is referred to as data mining. Basically data mining analyzes large amounts of data in a way that detects obscure facts, trends or inconsistencies in an efficient manner utilizing intelligent computer applications.

Case Study: ENRON

We briefly examine now the real life case study of ENRON in the light of the foregoing discussion.

Background:

ENRON was formed in 1985 when InterNorth company took over Houston Natural Gas. The company branched into many non-energy fields but their core business remained the transmission and distribution of power to large parts of the USA.

ENRON committed one of the biggest frauds in history. They did this by creating special purpose entities and false partnerships. A special purpose entity (SPE) was created to fulfill a specific objective. As stated before, SPEs are created to isolate firms from financial risks. A corporation can use the SPE to finance a large project without putting the entire firm at risk. One such SPE was LJM, a company created by Enron's Chief Financial Officer, to buy Enron's poorly performing stocks to boost Enron's financial statements.

How the Fraud was Perpetrated?

ENRON's downfall began when Enron's president of trading operations, Jeff Skillings convinced federal regulators to permit them to start using mark to market accountancy. In this accounting practice, the price of securities is recorded on a daily basis to record profit or loss. By using this method, Enron began to count projected incomes from long-term energy contracts as current income. It was thus 'funny money' which was projected and based on hypothetical trends and not collected for many years. The technique was used to inflate revenues by manipulating projections for future revenues.

Since these numbers were on books alone, the stock prices remained high, but Enron did not pay taxes for these projected incomes. In the meantime, ENRON had been buying other new ventures that seemed promising. Such acquisitions were growing at a fast rate. ENRON had been forming off balance sheet entities like LJM, LJM2 to move debt off the balance sheet and transfer risk of their other businesses. These special purpose entities (SPEs) were made to keep Enron's credit rate high. Enron came up with multiple ways to use the company's high stock rate to protect its investments in these other entities. They did this through SPEs called Raptors, "The Raptors were four constructs created in 2000, backed by Enron stock and used as place-keepers for the firm's earnings from asset values or investments--and, like the LJMs, keep hundreds of millions of dollars in debt off the books."[4] The Raptors were used to cover up losses in the stock value of their start-up businesses.

When the telecom industry suffered a loss, Enron suffered as well. Business analysts then began to look into the source of Enron's money. If Enron's stock fell beyond a certain point, the Raptor entities would collapse as they were backed by Enron's stock. According to the accounting rules, an independent investor is needed for a hedge to work, but Enron used one of their special purpose entities.

Enron had tangled itself in such a complex web of deals that it was no longer possible to see what was legal and what was illegal. Eventually, Enron's stock began to fall, as did the Raptors.

Discovering the Fraud:

On August 15, one of the Vice Presidents of Enron wrote an anonymous letter to the CEO of Enron, Ken Lay questioning Enron's accounting methods, specifically citing the Raptor transactions.

When Enron's stock fell below a certain point, the Raptor's losses began showing up on Enron's financial statements. On October 16, Enron announced a third quarter loss of $618 million. During 2001, Enron's stock fell from $86 to 30 cents. On October 22, the SEC began to investigate accounting methods adopted by Enron and its partnerships. In November, Enron's officials admitted that it had overstated his revenues by $57 million since 1997. In December, Enron filed for bankruptcy. ENRON collapsed and most of their executives were jailed.

Conclusion

One of the objectives of this research paper was to indicate the different types of accounts manipulation. The report shows how earnings management was used by a company to intentionally manipulate its earnings so that its figures match the pre-determined earnings target. However, there is a thin line between legal and illegal management of earnings since the financial statements can be made to appear in accordance with the forecasted target earnings within the limits of the generally accepted accounting principles. Thus one has to see whether the projected earnings are honestly defined and projected within admissible accounting bounds.

Income smoothing can be considered as a specific type of earnings management. The main aim of income smoothing as the report shows is to project untruthfully that profits have increased steadily. Smoothing is done to reduce fluctuations in reported earnings by either minimizing earnings when they are high and maximizing when they are low. Normally new management wants certain assets to look bad which results in the management tampering with their values. This type of behavior is normally referred to as “taking a bath.” Creative accounting mainly includes earnings management and also classificatory manipulations either related to income statement or the balance sheet.

The other objective of this paper was to identify the different ways in which accounts manipulation is detected. Detection of earnings management and income smoothing still needs further improvement. Their detection is primarily based on circumstantial evidence; if there is a motive like the CEO getting a nice compensation package, and evidence like having smaller levels of variance in accruals, then it is assumed that earnings management and income smoothing has occurred.

Despite the methods adopted to prevent account manipulation, it continues. The flaw lies in the rules of accountancy. There are many “grey areas” in accountancy that leave a lot of space for such manipulations to occur. For example, creating SPEs showed a way to financial officers to hide debt. They made the company look better than it actually was.

This report showed the mechanism behind the different types of manipulation. Once these are known it is easier to prevent them. Markers to point out early signs of fraud called ‘Red Flags’ are a useful instrument to prevent fraud. A list of these ‘Red Flags’ has been attached.

Legalization like the Sarbanes-Oxley Act, has been passed to ensure that investors have correct information to decide whether or not to invest in a company. Laws like these make it difficult for managers to manipulate accounts. The report gave the case study of one of the biggest example of accounting fraud committed by ENRON and showed how it was detected. In order to prevent commission of corporate fraud and protect the public it is necessary to have a strong regulatory framework which only the state can provide.

End Notes

[1] Stolowy and Bretan. “A Review of Research on Accounts Manipulation,” P. 12-24, Oxford Books, London, (2000).

[2]Stolowy and Bretan (2000). “A Review of Research on Accounts Manipulation”

[3] Stolowy and Bretan (2000). “A Review of Research on Accounts Manipulation”

[4] Levine (2006), “Fastow Tells of Loss-Hiding Enron Raptors”