

Part A

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## Introduction – Setting the Scene

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### 1.1 INTRODUCTION

Accounting scandals, creative accounting and fraud are perennial. They range from ancient Mesopotamia to the South Sea Bubble in 1720 to Enron and Parmalat today. They occur in all eras and in all countries. As accounting forms a central element of any business success or failure, the role of accounting is crucial in understanding such business scandals. Accounting enables businesses to keep a set of records to give investors and other users a picture of how well or badly the firm is doing. However, sometimes when businesses are doing badly managers are tempted to use accounting to enhance the apparent performance of the firm in an unjustified way. In addition, managers may wish to use the flexibility within accounting to serve a range of managerial interests such as to boost profits or increase assets. This can be done legally by using creative accounting to exploit the flexibility within accounting. Alternatively, in other cases management will indulge in false accounting or fraud. In this case, management will step outside the rules and regulations that govern accounting. Often this will be because management has got into serious financial difficulties and is looking for any way to postpone corporate collapse. Managers may use prohibited accounting techniques, falsify records or even record fictitious transactions. In some cases, companies start with creative accounting, but end up committing fraud.

This book aims to explore the role of accounting, particularly creative accounting and fraud, in accounting scandals. The terminology of creative accounting is explored first, and I then provide an overview of the three parts of the book. In Part A the background and context of creative accounting and fraud are explored. This part draws upon the established academic and professional literature and thinking about creative accounting and fraud. It provides an overview of the main terminology, looks at the creative accounting environment, the motivations for indulging in creative accounting and fraud, the methods of creative accounting and fraud, the evidence for creative accounting, impression management and, finally, looks at 18 major accounting scams and scandals across time. This is from ancient times until about 1980.

Part B looks at a series of international accounting scandals. Accounting scandals in 12 countries are investigated, covering Asia, Australasia, Europe and North America. Country specialists contribute chapters on Australia, China, Germany, Greece, India, Italy, Japan, the Netherlands, Spain, Sweden, the UK and the USA. In addition, there is a separate chapter dealing with the global banking crisis of 2008–9 from an accounting perspective. As can be

seen from their biographies, these experienced academics, using their knowledge and experience, provide an informed view of creative accounting, fraud and international accounting scandals in their respective countries. Finally, in Part C, I draw out some themes and implications from the country studies. In particular, I look at the impact of accounting scandals and synthesise the country studies using the data available from the individual chapters.

## 1.2 EXPLORING THE TERMS

The term ‘creative accounting’ came to prominence in a book published by Ian Griffiths in 1986. This book, called *Creative Accounting* (Griffiths, 1986), written in the UK context, began with the assertion that:

Every company in the country is fiddling its profits. Every set of accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse.

Any accountant worth his salt will confirm that this is no wild assertion. There is no argument over the extent and existence of this corporate contortionism, the only dispute might be over the way in which it is described. Such phrases as ‘cooking the books’, ‘fiddling the accounts’, and ‘corporate con trick’ may raise eyebrows where they cause people to infer that there is something illegal about this pastime. In fact, this deception is all in perfectly good taste. It is totally legitimate – it is creative accounting.

Since Griffiths’ book there have been many other explorations of creative accounting. In the UK, for example, there have been at least three books. *Accounting for Growth* by Terry Smith, a city analyst, looked at the reporting practices of 185 UK companies and found numerous examples of creative accounting. Hardly any companies were immune (Smith, 1991). Trevor Pijper, in *Creative Accounting: The Effectiveness of Financial Reporting in the UK*, investigated the situation in the UK at the start of the 1990s, finding many companies that had indulged in creative accounting. In particular, Pijper looked in depth at Polly Peck, a UK company that controversially collapsed in 1990 (Pijper, 1993). Finally, McBarnet and Whelan, in *Creative Accounting and the Cross-eyed Javelin Thrower*, explored UK financial reporting in 1999. They looked at many instances of creative accounting, especially those detected by the Financial Reporting and Review Panel, which ‘policed’ UK financial reporting (McBarnet and Whelan, 1999). Meanwhile, in the USA, a very influential book by Charles Mulford and Eugene Comiskey, entitled *The Financial Numbers Game*, investigated the pre-Enron financial reporting in the USA and documented numerous examples of both creative accounting and fraud. Enron is shown to be only one high-profile example of frequently occurring financial manipulations in the USA (Mulford and Comiskey, 2002). This leads us to the question, what exactly are creative accounting and fraud and how can they be distinguished from other commonly used terms such as earnings management, income smoothing and aggressive accounting?

### 1.2.1 Creative Accounting

Although creative accounting is a popularly used term, there is much less agreement on its exact definition than might be supposed. In essence, there is the wide definition, as

adopted by Mulford and Comiskey (2002, p. 15) in the USA and the narrower definition as practised in the UK. I give two representative definitions in Figure 1.1, and also the preferred definition that I will use in the book.

Generally, therefore, the wider US definition sees creative accounting as including fraud whereas the UK definition sees creative accounting as using the flexibility within the regulatory system, but excludes fraud. The preferred definition in this book sees creative accounting as excluding fraud. It is defined as ‘Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interests of the preparers not the users’. Creative accounting is thus seen as working within the regulatory system. It is thus not illegal. Companies using creative accounting are not breaking the law, just using the flexibility in accounting to serve their own interests.

Creative accounting is thus designed, by exploiting loopholes in the existing regulatory system, to serve preparers’ not users’ interests. In Europe, the financial statements of published companies, for example, are required to present a ‘true and fair’ view of the accounts. In the USA, a similar phrase ‘present fairly’ is used. In these Anglo-Saxon countries (and in many other countries) there is the overriding notion that accounts should faithfully represent economic reality.<sup>1</sup> Users are supposed to be given a set of financial accounts which reflect economic reality. Creative accounting, by contrast, privileges the interests of the preparers (i.e. the managers). It is able to do this because of the fundamental need for financial reports to be flexible so as to give a true and fair view of accounts. All companies are different and operate in different environments.

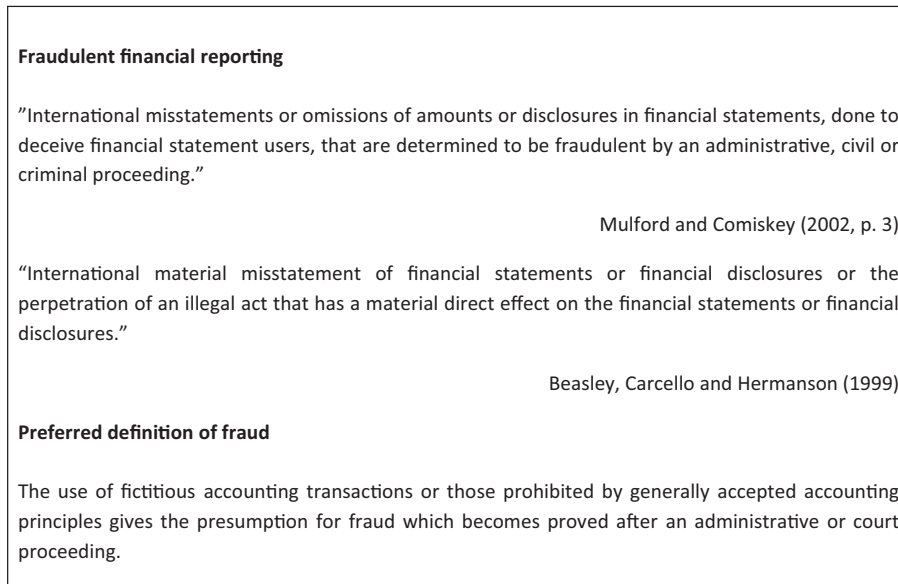
The flexibility in financial reporting is meant to reflect this. However, this flexibility can be used, and often is, for creative accounting. As Figure 1.2 shows, there is a continuum from no flexibility to flexibility to give a true and fair view, to flexibility to give a creative view, to flexibility to give a fraudulent view.

Thus, if there is no flexibility, there will be no creative accounting. However, there will also not be a true and fair view. This is unacceptable as a fundamental purpose of accounting is to provide users, generally shareholders, with information so that they can make economic decisions such as whether to buy, sell or hold shares. A regulatory framework, which varies from country to country but may include national standards (most countries, e.g. the UK and the USA), international standards (widely used), company law (some countries, such as the UK and Germany) or independent accounting commissions (such as the Securities and Exchange Commission in the USA) has, therefore, grown up to set up accounting rules and regulations which companies and other organizations should follow so as to deliver ‘a true and fair view’ to account users. This is the ideal scenario, where the preparers of accounts use the flexibility in the accounts to deliver ‘a true and fair view’. However, the flexibility within the accounting rules and regulations opens the door for the managers to use creative accounting. In a sense, there is nothing wrong in this as they are not breaking any rules. However, they are departing from the basic purpose of accounting, which is to provide users with a true and fair view. When the managers actually go outside the regulatory framework, they are not then complying with existing regulations. Technically, they may then be indulging in false accounting or in fraud. However, this is a difficult

<sup>1</sup> For ease of understanding the phrase ‘true and fair’ commonly used in Europe is used in this book to convey the notion of economic reality.

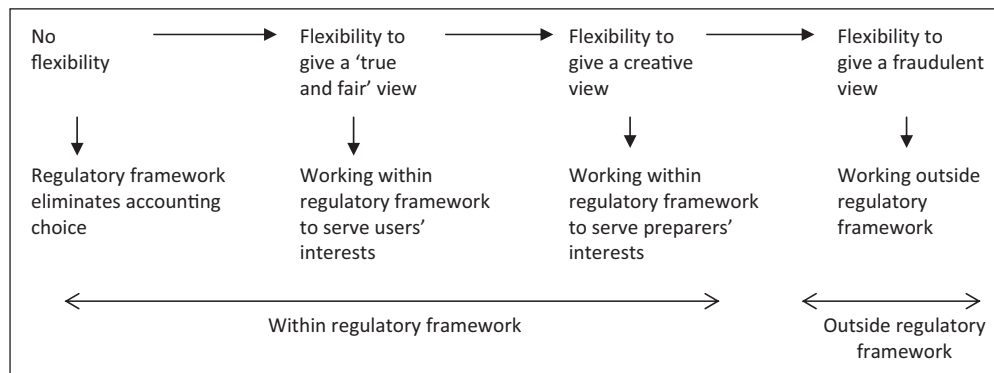
<p><b>Narrow definitions of creative accounting</b></p> <p>“The exploitation of loopholes in financial regulation in order to gain advantage or present figures in a misleadingly favourable light.”</p> <p style="text-align: right;"><i>Oxford Dictionary of English</i></p> <p>“A form of accounting which, while complying with all regulations, nevertheless gives a biased impression (generally favourable) of the company’s performance.”</p> <p style="text-align: right;">Chartered Institute of Management Accounting (2000), <i>Official Terminology</i></p> <p><b>Wide definition of creative accounting</b></p> <p>“Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, both within and beyond the boundaries of generally accepted accounting principles, and fraudulent financial reporting. Also included are steps taken toward earnings management and income smoothing.”</p> <p style="text-align: right;">Mulford and Comiskey (2002, p. 15)</p> <p><b>Preferred definition of creative accounting</b></p> <p>“Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interests of the preparers not the users.”</p> <p><b>Fraud</b></p> <p>“A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”</p> <p style="text-align: right;"><i>Black’s Law Dictionary</i>, 7th edn (1999)</p> <p>“... ‘fraud’ comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by one or more individuals among management, employees, or third parties. Fraud may involve:</p> <ul style="list-style-type: none"><li>• Falsification or alteration of accounting records or other documents.</li><li>• Misappropriation of assets or theft.</li><li>• Suppression or omission of the effects of transactions from records or documents.</li><li>• Recording of transactions without substance.</li><li>• Intentional misapplication of accounting policies.</li><li>• Wilful misrepresentation of transactions or of an entity’s state of affairs.”</li></ul> <p style="text-align: right;">Auditing Standards Board, <i>Statement of Auditing Standard</i>, SAS 110</p>
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**Figure 1.1** Definitions of creative accounting and fraud



**Figure 1.1** Definitions of creative accounting and fraud (*Continued*)

area. False accounting or fraud, in effect, must be proved in a court of law or by a regulatory body.



**Figure 1.2** Flexibility within accounting

Source: Adapted from Jones (2006).

### 1.2.2 Fraud

The difference between creative accounting and fraud is, therefore, essentially that creative accounting is working within the regulatory framework. An exact definition of fraud is elusive; for instance, in the UK there is no legal definition of fraud (Levi, Information Gathering Working Party and Doig, 1999). However, fraud involves working outside the

regulatory framework. In each country, the definition of fraud will be slightly different; however, in essence, it involves breaking the law and/or violating the regulatory framework. Fraud can be committed by individuals or management. For individuals, accounting fraud would generally involve theft of, for example, inventory or cash. For management, there is also the crime of preparing false financial statements intended to deceive users. When there are suspicions that fraud is taking place, then we can say there is alleged fraud. However, it is only when there is a proven court case that we have a demonstrable case of fraud. Thus, in Polly Peck, a UK company that collapsed in 1991, Asil Nadir has been accused of fraud and false accounting by the Serious Fraud Office in the UK but has not yet been brought to court. The charges remain alleged, with Asil Nadir protesting his innocence. However, in the USA Kenneth Lay and Jeffrey Skilling were both brought to trial and found guilty of accounting fraud at Enron (White, 2006). Also in the USA, the Rigas family who owned Adelphi Communications, a cable operator, were accused of a whole range of accounting malpractices in June 2002. 'The Justice Department and the U.S. Postal Inspection Service charged the five executives with securities, wire and bank fraud, saying they "looted Adelphia on a massive scale" and used it as a "personal piggy bank". Rigas private funds sloshed with Adelphia's in the same cash-management system' (Lieberman and Farrell, 2002, p. 3). For their role in the fraud, key members of the founding family were convicted of financial statement fraud.

Financial statement fraud is a subset of fraud in general. There have been some attempts to estimate both the extent of fraud and of financial statement fraud, which is the main focus of this particular book. The most comprehensive study, particularly of financial statement fraud, is provided by Beasley, Carcello and Hermanson (1999) in a research report commissioned by the Treadway Commission in the USA. This is dealt with, in depth, in Chapter 5. I therefore focus here on other indications of the extent of fraud in four studies from the UK, USA, Australia and globally.

First, in the UK the Fraud Advisory Panel (Levi, Information Gathering Party and Doig, 1999) outlined various ranges of the annual cost of major frauds in the UK. These ranged from £16 billion from the Association of British Insurers; £5 billion from the Serious Fraud Office as well as Ernst & Young; £1–2 billion from benefit fraud and £400–700 million from KPMG. The Serious Fraud Office workload of alleged frauds in April 1997 was over £2 billion and the most common frauds were those on investors and creditors, and on banks and other institutions. The number of cases of false accounting ranged from a high of 2106 in 1989 to a low of 1395 in 1995 (from 1986–96). The most frequently occurring type of fraud was false documentations (£977 000) followed by theft of assets (£640 100) in 1997/98.

In the USA, the Association of Certified Fraud Examiners in 1996 published a Fraud Report (Association of Certified Fraud Examiners, 1996). It collected the experience of 2608 Certified Fraud Examiners. They studied \$15 billion of cases, and established that fraud and abuse cost US organisations more than \$400 billion annually. Men commit 75 % of frauds, with small businesses being the most vulnerable. The most common account affected by fraud was cash, with fraudulent financial statements accounting for about 5 % of cases.

Third, in Australia and New Zealand, KPMG carried out a Fraud Survey in 2004 (KPMG, 2004). Its main findings were that 45 % of its respondents experienced at least one fraud, with a loss of \$456.7 million and 27 657 instances of fraud. The typical fraudster was male, about 31 years old, with no prior record of dishonesty, in a non-management

position who misappropriated funds of \$337 734 and acting alone was motivated by greed. The most common fraud by managers was the theft of inventory/plant, followed by the misappropriation of funds, cheque forgery and false invoicing.

Fourth, Ernst & Young carry out an annual survey of fraud. Their 2002 survey found that 85 % of frauds were by insiders on the payroll (Ernst & Young, 2002). Generally, more frauds happened in less developed regions, such as Africa, than in more developed regions, like Europe. The size of more than half the losses was less than \$100 000.

In general, financial statement fraud can be categorised in two major ways. First, it is when a company uses accounting practices which are outside those permitted by the regulatory framework. In other words, they are not allowed by accounting standards or accounting laws. Generally, to be designated as fraud these practices will have been shown to be fraudulent in a court of law. Often, it is difficult to distinguish between creative accounting and fraud as it will all be a matter of interpreting the basic assumptions that underpin accounting.

The second major type of fraud is where transactions have been invented. In other words, non-existent transactions have been recorded in the books, such as fictitious sales or fictitious inventory. For example, in the USA there have been two high-profile fraud cases in the twentieth century that have involved substantial fraud. In McKesson and Robbins a fictitious subsidiary had been invented, while in the case of the Equity Funding Corporation of America a whole edifice of false insurance policies had been constructed.

### 1.2.3 Other Terms

There are many other terms which are used in connection with creative accounting. Some of these are discussed below. They are also set out more formally in Figure 1.3.

<p><b>Aggressive accounting</b></p> <p>This is a very similar term to creative accounting. It involves the use of accounting rules and regulations to deliver a particular result, but working within the regulatory system.</p>
<p><b>Earnings management</b></p> <p>This involves using the flexibility within accounting to deliver a predetermined profit. This may be, for example, to meet a consensus earnings figure expected by city analysts.</p>
<p><b>Impression management</b></p> <p>This represents an attempt by the management of the firm to give to users the impression of the firm which managers want. This will include creative accounting. However, impression management is more usually associated with presentational issues such as accounting narratives and graphs.</p>
<p><b>Profit smoothing</b></p> <p>This involves the use of accounting techniques to ensure a steady profit. In other words, the natural peaks and troughs of accounting profit are eliminated.</p>

**Figure 1.3** Other terms used in creative accounting

### ***1.2.3.1 Aggressive Accounting***

This term is broadly the same as creative accounting. It is the use of accounting rules and regulations to deliver a particular set of financial results. It involves the deliberate choice of accounting figures which will have more to do with achieving a specific managerial objective, such as increased earnings, rather than presenting a true and fair view. In this book, aggressive accounting is seen to be broadly synonymous with creative accounting.

### ***1.2.3.2 Earnings Management***

Earnings management is a term commonly used by academics. There have been numerous academic papers written on all aspects of the subject. Earnings management is where managers manage the accounts in order to achieve a specific objective. So, for example, it is common practice for analysts to issue profit forecasts for firms trading on the world's stock exchanges. Firms like to meet these forecasts because if they do not, share prices of the errant companies often fall. Firms which are falling short of their targets will, therefore, sometimes seek to manage their profits. There are many other examples of earnings management. For example, to ensure that debt covenants are not breached, for profit smoothing, or to sustain earnings and share price in takeovers. A fuller discussion of the earnings management literature is given in Chapter 5.

### ***1.2.3.3 Impression Management***

Impression management involves managers influencing the financial reports in their favour. It is not fraudulent. It is a very wide term and although it includes creative accounting, it is normally more associated with the presentational aspects of reporting such as accounting narratives, graphs and photographs. Accounting narratives, such as the Chairman's Statement in the UK and the Management Discussion and Analysis in the USA, may be subject to narrative enhancement. In other words, management may present news selectively, bias the news or use attribution (attribute good news to themselves but attribute bad news to uncontrollable external influences such as world events).

There are many possible ways in which graphs might be used creatively. For example, they may only be used when there is a favourable trend to display. Or alternatively they might be drawn so as to enhance favourable results and downplay unfavourable results. Finally, photographs may be used to present an overall image of the company. For example, many of the high-profile oil companies use nature photographs to try to present a green image. A fuller discussion of the impression management literature is provided in Chapter 6.

### ***1.2.3.4 Profit Smoothing***

The stock market generally rewards companies that produce steady profits, but penalises those with erratic profits. Companies therefore will prefer to report steady year-on-year growth rather than confront the market with volatile profits. Company managers will,

therefore, use various techniques to smooth profits. Essentially this means massaging down high profits and enhancing poor profits. Fortunately for the creative accountant, lots of opportunities arise for massaging profits. The company can, for example, use provision or ‘cookie jar’ accounting. This is where a firm may set up a provision for an expense one year. This will reduce profits. The next year it may reverse the provision saying that the expenses it expected to incur were overestimated. Consequently, in year two profits will be more because of the reversed provision. Companies can then save up their profits for a rainy day.

### 1.3 STRUCTURE OF THE BOOK

I will now briefly outline the contents of the rest of the book. In the rest of Part A, the context of creative accounting is examined. This draws upon existing academic and professional literature. In Chapter 2, I look at the main actors involved in creative accounting: managers, investment analysts, auditors, regulators, shareholders, merchant bankers and other users. The different interests which these groups have are highlighted. Managers may benefit from creative accounting as it gives them the flexibility to deliver the results they want. Existing shareholders may also gain, unless the company collapses, due to its enhanced share prices caused by creative accounting. For merchant bankers, there may be potentially lucrative fees to be earned by creating complex creative accounting schemes. By contrast, other groups are harmed by creative accounting. Regulators dislike creative accounting because it can be used to bypass accounting rules and undermines the currency of accounting. Shareholders, and other users, may suffer if the company collapses. For auditors, creative accounting creates a potential conflict with management, and also a potential problem if the company collapses as the auditor may be blamed.

The motivations to indulge in creative accounting and fraud are varied and are examined in Chapter 3. There are two sets of general incentives: personal and city. The personal incentives relate to the managers. They may wish, for example, to try to increase their salaries, bonuses, enhance their shares and share options. In other words, there are incentives for them to manipulate accounting policies in order to maximise their own personal benefit. They also may wish to meet city expectations. If the business does not deliver the expected profits then its share price may be punished. As a result, managers will try to meet analysts’ expectations and may indulge in profit smoothing or in other creative accounting techniques.

There are also a range of special circumstances. For example, managers may wish to increase net assets so as to stop breaching debt covenants or creative accounting may be used to increase the share price of a company when it is purchasing another through a share issue. In certain circumstances, there may also be incentives to reduce profits. For example, in regulated industries when governments may penalise excessive profits or in situations where a new incoming management team may wish to make the current year’s profits worse so that future profits will look better.

There are numerous ways of exploiting the inherent flexibility of accounting so as to indulge in creative accounting. In Chapter 4, I look at four main strategies: increasing income, decreasing expenses, increasing assets and decreasing liabilities.

### **1.3.1 Increase Income**

The aim here is to maximise revenues which will feed directly into profit. There are several main ways. Generally, these will involve the premature recognition of sales or the maximisation of other income such as interest receivable or non-operating profit. In most cases, these techniques will exploit the flexibility in accounting regulation. However, in some cases completely fictitious sales will be created. At its most extreme, as in McKesson and Robbins in the USA in 1931, a wholly fictitious trading subsidiary was set up. More recently in Germany, as we will see in Chapter 10, at Flowtex, fictitious drilling machines were ‘manufactured’ and ‘leased’.

### **1.3.2 Decrease Expenses**

By decreasing expenses, profit is naturally increased. Expenses can be decreased in a number of ways. For example, in provision accounting, in good years expenses will be set up for provisions such as restructuring. Then, in bad years these provisions can be fed back into the profit and loss account reducing expenses and increasing profits. Such provisions are particularly popular on acquisition or when a new management takes over a company. Other ways of decreasing expenses can be (i) to capitalise expenses such as interest payable so that they are recorded as assets not expenses, or (ii) to lengthen asset lives so as to reduce depreciation, or (iii) to reduce bad debts. Finally, a good way of decreasing expenses is to increase closing inventory. Closing inventory is taken off cost of sales and thus by increasing closing inventory, cost of sales is reduced and profits increased.

### **1.3.3 Increase Assets**

Many of the strategies that decreased expenses will also boost assets. Thus, lengthening depreciation levels and capitalising interest will boost fixed assets, while reducing bad debts will increase accounts receivable. However, some other techniques can be used to increase assets. For example, goodwill, brands and other intangible assets can be enhanced in value and included in the accounts. In addition, tangible fixed accounts can be revalued.

### **1.3.4 Decrease Liabilities**

Another way of increasing net assets is by decreasing liabilities. Two common ways are off-balance sheet financing and reclassifying debt as equity. Off-balance sheet financing attempts to quarantine debt in subsidiary companies which are not then consolidated. Enron, for example, set up numerous off-balance sheet subsidiaries. Reclassifying debt as equity seeks to classify outside, third-party debt as insider capital. This serves to reduce the apparent levels of debt.

There have been many studies into creative accounting, and both descriptive and statistical studies are discussed in Chapter 5. The descriptive studies, reports and books discuss and provide illustrative examples of creative accounting. In the statistical studies, large numbers

of company accounts are typically analysed by accounting academics to see if they can discern any aggregate evidence of creative accounting.

The eight books and two reports present an impressive array of evidence about creative accounting and fraud both in the UK and the USA. Innovative methods and illustrations of creative accounting are documented. For example, UBS Phillips & Drew in *Accounting for Growth* in 1991 looked at 185 well-known UK companies' annual reports. They identified 11 creative accounting techniques and then showed which UK companies used them as well as using vignettes to illustrate individual practices (UBS Phillips & Drew, 1991).

The statistical studies have looked at a range of issues and generally have found evidence supportive of the existence of creative accounting.

- Companies were found to income smooth. In other words, companies increased profits in poor years, but decreased them in good years.
- Companies used creative accounting to meet their own annual earnings forecasts and also those of market analysts.
- Managers manipulated earnings so that they could receive higher bonuses.
- Companies manipulated earnings and net asset values so as not to breach their debt covenants.
- Certain companies, particularly those in regulated industries, manipulated their earnings so as to ward off government interference.
- When there was a change of management, especially when the changes were forced, then incoming managers, in particular, were found to decrease income in the year of changeover so that future profits could be enhanced.
- In takeover situations, it was found that acquiring companies' earnings increased before the acquisition. This increased share prices and thus meant acquiring companies had to pay fewer shares for their acquisitions. Similarly, company earnings increased before a share issue.
- Those firms which failed to meet analysts' expectations were more likely to make disclosures to attempt to manage stock market reactions.

The use of accounting narratives, graphs and photographs to manage impressions is outlined in Chapter 6. Impression management is where managers present the numbers and narratives in an annual report in such a way as to give users a particular impression of the firm's results. Managers may, for example, use accounting narratives to:

- (i) stress the positive and downplay the negative;
- (ii) convey bad news by using technical language which is difficult to read;
- (iii) use differential reporting, with companies reporting bad news focusing less on the actual results and preferring to focus on the future;
- (iv) use attribution to take the credit themselves for good news, while blaming the environment for bad news.

Managers can use graphs for impression management in three ways. First, by being selective in their use and presenting only those graphs which convey good news (selectivity). Second, by drawing graphs which present an enhanced picture of the company's underlying performance (measurement distortion). Third, by enhancing the presentation of graphs using a variety of presentational techniques (presentational enhancement). Finally, photographs

can be used to create an overall impression of a firm. Thus, companies selling alcohol may try to convey a fun-loving, exciting environment.

Accounting scandals have always been with us. The role of creative accounting and fraud in them has always been fairly fluid. One period's creative accounting can, after a change in accounting rules and regulations, become a subsequent period's fraud. Chapter 7 looks at accounting scandals over time and shows the role played by creative accounting and fraud.

Eighteen different examples of accounting scams and scandals are outlined across five time periods: the ancient and medieval period; the seventeenth and eighteenth centuries; the nineteenth century; the twentieth century up to 1945; and the twentieth century from 1945 up to the 1980s. The cases range from the doctoring of a cruciform monument in the second millennium BC in Mesopotamia in an attempt to convince the King that the revenues of the temple were greater than they actually were to the Renouf and Judge corporations in New Zealand in the 1980s, where creative accounting was apparently used to enhance earnings and share price (see Chapter 7). Geographically, the countries where scandals occur are diverse: Australia, Italy, Mesopotamia, New Zealand, the UK and the USA.

These illustrative examples include clear examples of creative accounting, such as P&O's manipulation of the results of its New Zealand subsidiary at the start of the twentieth century so as to transfer funds secretly to the UK to frauds such as Equity Funding of America. In this latter case, more than \$3 billion life insurance policies were found to be fraudulent.

In Part B, we look at accounting scandals in 12 different countries. The main countries (with the authors and the most important cases presented) are shown in Table 1.1.

The author(s) of each chapter were asked to analyse cases of creative accounting, fraud and accounting scandals in their respective countries since the 1980s. In particular, they were asked to discuss, explain and evaluate the major accounting scandals. In addition, as a final chapter (Chapter 20) in this Part, we look at the global banking crisis. This chapter written by Simon Norton deals with the major recent US cases of Bear Stearns, Lehman Brothers and Madoff Securities International Ltd.

In Table 1.1, I list the countries, the authors and the major cases in each country. Usually, this is one case, such as HIH in Australia, but in Germany, the Netherlands, Spain, Sweden and the USA, two cases are covered. In Japan, three major cases are identified across the period. As we see below, the authors discuss not only these major cases, but also instances of creative accounting and other important scandals that have occurred, usually post-1980. I now look, briefly, at these major chapters.

Gary Carnegie and Brendan O'Connell look at accounting scandals in Australia in Chapter 8. They demonstrate that Australia has a long history of accounting scandals. Five case studies are examined, in depth: Adelaide Steamship, Bond Corporation, Harris Scarfe, One.Tel and HIH. In particular, they focus on HIH, which in 2001 was the largest ever corporate collapse in Australia's history. They show that HIH collapsed through underprovisioning and from mismanagement.

Accounting scandals in China are investigated in Chapter 9 by Catherine Chen, Yuanyuan Hu and Jason Xiao. They focus on six accounting scandals (Yuanye, Great Wall Fund Raising, Hongguang, Daqing Lianyi, Kangsai Group and Lantian Gufen) before carrying out an in-depth study into Zhenzhou Baiwen. Zhenzhou Baiwen, a company involved in household appliances and department stores, appeared to be very successful. However, at

**Table 1.1** Main countries discussed in this book

Chapter	Country	Authors	Major cases
8	Australia	Garry Carnegie Brendan O’Connell	HIH Insurance
9	China	Catherine Chen Yuanyuan Hu Jason Xiao	Zhenzhou Baiwen
10	Germany	Hansrudi Lenz	ComRoad Flowtex
11	Greece	George Kontos Maria Krambia-Kapardis Nikolaos Milonas	Bank of Crete
12	India	Bhabatosh Banerjee	Satyam
13	Italy	Andrea Melis	Parmalat
14	Japan	Kazuyuki Suda	Kanebo Livedoor Nikko Cordial
15	Netherlands	Henk Langendijk	Royal Ahold
16	Spain	Nieves Carrera	Afinsa and Fórum Filatélico
17	Sweden	Gunnar Rimmel Kristina Jonäll	ABB Skandia
18	United Kingdom	David Gwilliam Richard Jackson	Polly Peck
19	United States	Charles Mulford Eugene Comiskey	Enron WorldCom

the turn of the new millennium it ran into trouble and the authors show that its apparent success was based on creative accounting and fictitious sales.

Chapter 10, on accounting scandals in Germany, was written by Hansrudi Lenz. He looks at six important cases: Co-op, Balsam, Bremer Vulkan Verbund, Philipp Holzmann, Flowtex and ComRoad. Flowtex and ComRoad are particularly interesting. They both involve extensive frauds. Flowtex manufactured and leased fictitious drilling equipment, while ComRoad’s CEO and his wife had virtually constructed a fictitious customer/supplier.

Accounting scandals in another European country, Greece, are analysed in Chapter 11. Three cases are singled out for special attention by George Kontos, Maria Krambia-Kapardis and Nikolaos Milonas: ETBA Finance, Dynamic Life and the Bank of Crete. The Bank of Crete was a major scandal in which one man, George Koskotas, systematically used weaknesses in the internal accounting system of the bank to embezzle huge sums of money. The wider implications of the case for the Greek economic and political structure are examined.

In Chapter 12 we move to India. Bhabatosh Banerjee demonstrates first that creative accounting is very common in India. He outlines eight different instances of creative accounting, ranging from the creation and write-back of provisions by Bombay Dyeing and Manufacturing Company to the capitalisation of interest by companies such as the Oil and Natural Gas Commission. Only one major Indian case is dealt with, Satyam – not because there are no more, but because the Indian judicial process is very long and they are still sub judice.

Andrea Melis investigates creative accounting and accounting scandals in Italy in Chapter 13. He looks at Pirelli's legal but creative use of consolidation accounting, before looking at the topics of stock options and creative accounting within football clubs. Then, Professor Melis investigates the most spectacular accounting fraud in Italy: Parmalat. He demonstrates that at Parmalat there was falsification of earnings, assets and liabilities with poor internal controls and serious failings by the external auditors.

Next, in Chapter 14, Kazuyuki Suda investigates a series of high-profile accounting scandals in Japan. Ten scandals are analysed: Sanyo Special Steel, Fuji Sash, Sawako, Sanyo Electric, Livedoor, Morimoto-gumi, Nikko Cordial, Riccar, Yamaichi and Kanebo. These scandals were apparently motivated by the avoidance of bankruptcy and by the need to fulfil public construction contracts and managerial compensation. The Kanebo case is particularly interesting, and represents the largest ever amount of earnings manipulation in Japan. It resulted in the break-up of the auditing firm ChuoAoyama PricewaterhouseCoopers.

In Chapter 15, Henk Langendijk looks at the Dutch experience of accounting scandals. First of all, he looks at two relatively minor accounting scandals at Rijn Schelde-Verolme (RSV) and Fokker. He then focuses on one major company accounting scandal, Royal Ahold. At Royal Ahold, consolidation and vendor allowances were both abused.

In Chapter 16, Nieves Carrera examines major financial scandals in Spain. First of all, accounting scandals in the banking sector, such as Caja Rural de Jaen and Banesto, are discussed. An important scandal in the investment services sector, Gescartera, is then studied. The third sector that Professor Carrera examines is the real estate sector, with the case of Promotora Social de Viviendas and Iniciativas de Gestión de Servicios. Finally, two major scandals involving investment in stamps, Afinsa and Fórum Filatélico, are examined. Both companies are found to have indulged in many accounting irregularities.

The Swedish chapter, Chapter 17, was written by Gunnar Rimmel and Kristina Jonäll, who look at four major accounting scandals: Fermenta, Prosolvía, ABB and Skandia. The latter two cases are covered in depth. ABB's accounting was found to be hard to decipher, with continual reorganisations and the redemption of its own shares. Skandia, an insurance company, used embedded value accounting which led the company to appear to be prosperous despite significant negative cash flows.

In Chapter 18, David Gwilliam and Richard Jackson investigate creative accounting and fraud in the UK. They analyse three main cases: BCCI, Mirror Group and Polly Peck. They focus on Polly Peck. They show that this fast-growing company, involved in food purchase, production and packaging, seemingly adopted very dubious accounting practices. In particular, weak internal controls apparently allowed huge sums of cash to be transferred out of the UK to Turkey. In addition, many of the financial statements for Polly Peck's Turkish subsidiaries appear to have been vastly inflated. Asil Nadir, who ran the company, has, however, always protested his innocence and in August 2010 returned to face trial.

The penultimate chapter in Part B, Chapter 19, is on accounting scandals in the USA. Charles Mulford and Eugene Comiskey demonstrate that in the USA since the 1990s there have been numerous cases of premature or fictitious revenue recognition, capitalisation of costs and/or extended amortisation periods, overstated assets and/or understated liabilities, and other creative accounting practices such as the abuse of restructuring charges and creative financial statement classification. They focus, in particular, upon Enron and WorldCom. They show that Enron's fraud involved off-balance sheet liabilities, fictitious income and misreported cash flow. Meanwhile, at WorldCom, the fraud – although on a massive scale – was quite simple, involving, in particular, the capitalisation of operating expenses.

The final chapter in this section, Chapter 20, is based on the recent worldwide banking crisis. Simon Norton shows the causes of the crisis and how accounting has been implicated in corporate collapses. He demonstrates the role played by fair value and also by creative accounting techniques such as off-balance sheet financing. He focuses on three important cases: Lehman Brothers, Madoff Investment Securities and Bear Stearns. Lehman Brothers is shown to involve creative accounting rather than fraud. Madoff's fraud involved a 'Ponzi' scheme where new investors essentially funded returns to existing investors. Bear Stearns is an example of creative accounting being used to repackage higher risk products to lower risk ones.

In Part C of the book, I attempt to synthesise and discuss the overall findings. In Chapter 21, I look at some themes which emerged from the various chapters. I look at the major methods used, as far as they can be identified, from the various chapters. There were examples of increasing income, decreasing expenses, increasing assets and decreasing liabilities. Particularly popular were attempts to boost earnings through related parties, capitalising expenses and off-balance sheet financing. There were also frequent cases of fraud, such as embezzlement and fictitious transactions. I also look at the incentives for creative accounting and fraud. Generally, from the evidence in the individual chapters, this was most often used to cover up bad performance, for personal benefit and to meet listing requirements.

In Chapter 21, I also look at three themes which emerged from prior chapters: the role of overstrong personalities, the failure of internal controls and of internal auditing. First, there were many examples of how overstrong individuals used the power of their personalities to carry all before them. They managed to convince investors and the wider business world to trust them. Second, many instances of a failure of internal controls were identified. These included ineffective boards of directors, lack of independent scrutiny via non-executive directors or supervisory boards, and failure of internal audit. Finally, in many cases across the accounting scandals, there was evidence of a severe failure of external auditing.

In Chapter 22, the penultimate chapter, I investigate, using the evidence from prior country chapters and the longitudinal chapter, the immediate and long-term impact of creative accounting and the international accounting scandals. In the short term, there are effects upon both insiders and outsiders. Directors are most often fined or jailed. Auditors are often sanctioned, while investors and creditors often lose money. The longer-term effects may involve new regulatory measures to stop abuses. Over time, the regulatory framework becomes more sophisticated.

Finally, in Chapter 23, I summarise the main findings from the book in terms of prior literature and the individual country studies. I look at certain key themes examined, such as the motivation for individuals to indulge in creative accounting and fraud, the main

methods of creative accounting, the role of overstrong personalities, the failures of internal controls and external auditing. I then consider some lessons for the future. I examine how the potential for creative accounting and fraud is enhanced by motives and environmental opportunities. I then evaluate some potential solutions, such as more appropriate rewards and incentives, better regulations, enhanced supervision, harsher penalties and improved ethics. Finally, I suggest that whatever the attempts to prevent creative accounting and fraud, history suggests that international accounting scandals are likely to continue in one form or another.

## 1.4 CONCLUSION

The term ‘creative accounting’ can be defined in many ways. In particular, a broad definition of the term includes fraud. The narrower definition, as preferred by this book, sees creative accounting as using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interests of the preparers not the users. Creative accounting is not therefore illegal, and works within the current regulatory framework. Fraud, by contrast, is illegal. Fraud involves working outside the regulatory framework. The term ‘fraud’, however, in this book is reserved for cases which have been tried in court or by regulatory commissions. Otherwise, the term ‘alleged fraud’ is used. Other terms associated with creative accounting are aggressive accounting, earnings management, impression management and profit smoothing. Aggressive accounting in this book is broadly considered to be synonymous with creative accounting. Earnings management involves using the flexibility within accounting to deliver a predetermined profit. This may be, for example, to meet a consensus earnings figure expected by city analysts or to profit smooth. Impression management can include earnings management. More particularly, it is concerned with the presentation of the accounts, in particular accounting narratives, graphs and photographs. Finally, profit smoothing involves the use of accounting techniques to ensure a steady profit. In other words, the natural peaks and troughs of accounting profit are eliminated.

This book looks at the use of creative accounting and fraud in a global context across 12 countries from Asia, Australasia, Europe and North America. Representatives of both developed and developing countries are thus included. The motives, methods and consequences of the major accounting scandals are examined. There is also consideration of the role played by accounting in recent bank failures. Then, some overall conclusions are drawn which identify the major motivations for the scandals, the major methods of creative accounting and fraud used, the role of overstrong individuals, internal and external control failures, and regulatory and other consequences.

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