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WHITE-COLLAR CRIME

Aggressive accounting vs. fraudulent accounting

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The line between aggressive accounting and fraudulent accounting can be finer than many readers of this article may like to believe.

It is well-recognised in the finance profession that preparing financial statements involves exercising judgment and the use of assumptions; meaning that the financial statements produced may show different results than if they had been prepared for the same entity, for the same period, but by another equally qualified professional. Both financial statements can still meet the overriding requirement of presenting a true and fair view. This flexibility can create opportunities for so-called 'earnings management', where the discretion offered to management is utilised to influence the reported results. Some argue that many large companies legally engage in earnings management, perhaps to meet analysts' expectations, despite the practice coming under increasing scrutiny from auditors, authorities and investors.

The use of aggressive accounting techniques is not necessarily fraudulent. However it may be the start of a slippery slope, where legitimate earnings

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management descends into earnings manipulation or fraudulent accounting – the slippery slope has been described as 'playing the system', then 'beating the system', and ultimately 'going outside the system'. The classic 'fraud triangle' requires each of the following circumstances to prevail: (i) motivation/pressure; (ii) opportunity and (iii) rationalisation of actions.

Revenue can be surprisingly susceptible to manipulation. Employing methods that take advantage of timing differences, mostly resulting in premature revenue recognition, is relatively straightforward. However, with cut-off testing procedures firmly on every decent auditor's work plan, more sophisticated methods have been developed. A scheme termed 'channel stuffing', where a company ships products in excess of a customer's requirements towards the end of an accounting period in order to inflate revenues, became particularly controversial in the late 1990s and early 2000s. Often the customer will be enticed to transact by a variety of incentives, such as discounted prices or extended payment terms. Regular use of such tactics may not be commercially wise – as customers can take advantage by delaying placing orders in the knowledge that more favourable terms will become available near the supplier's period-end – but can nevertheless be legitimate from a legal and accounting perspective. Whilst authorities on both sides of the Atlantic have challenged the legitimacy of revenue recognised in these circumstances, they have experienced varying degrees of success in pursuing senior management involved.

Such arrangements become even more questionable when accompanied by other, often undisclosed, conditions agreed with the customer. Take for instance, the case of an Eastern European company which managed to generate 25 percent of its annual revenue by holding a 'special sales promotion' towards the year-end, enticing customers with extended credit terms. A closer inspection of the accounting records for the following year found that the vast majority of the products were in fact soon returned to the company. Worse still, those subsequent transactions were not recorded as returns, reducing revenue in the following year, but were instead recorded as purchases of finished goods. Further, in the case of one particular customer, the side-arrangements even included compensation for warehousing costs incurred by the customer in storing the goods until returned. This sounded the alarm for potentially fraudulent activity. Similarly, a company sells an asset or commodity and at the same time agrees to buy back the same asset in the future for the same or similar price. This is known as 'round-tripping' and featured in many of the biggest accounting scandals of the early 2000s in energy and telecom companies.

The management of the Eastern European company mentioned earlier did not stop at 'promotional sales'. Significant interest revenue was recorded from penalty interest accrued on overdue receivables. Whilst the company's general terms and conditions and sales invoices referred to its right to charge penalty interest, several factors aroused suspicion as to the legitimacy of the revenue. Firstly, the company did not notify the relevant customers of the interest amounts calculated and charged to their accounts, and made no effort to seek to collect the amounts allegedly due. Secondly, the total amount was recorded using a single year-end journal entry, despite the interest purportedly relating to amounts accrued throughout the year. Finally, a series of subsequent transactions

involving the interest receivables appeared highly questionable – the full amount of the interest receivable was 'sold' at 93 percent of face value, giving rise to a receivable from another entity; that new receivable was itself then sold on to yet another company (whose financial statements indicated its primary activities as motor vehicle repair, sales and rental); and ultimately purchased by one of the company directors – it therefore smelt suspiciously like an undisclosed related party transaction. Essentially, the company had tried to legitimise the interest revenue by producing documentation purportedly evidencing onward sales of the receivables, akin to factoring agreements, but which ultimately lacked any commercial sense and were deemed, together with the associated 'interest revenue', to be a sham.

Aside from revenue, the accounts also recorded a significant profit on a disposal of fixed assets arising from the sale and leaseback of certain assets, which was recognised at the inception of the lease. The applicable accounting (GAAP) rules allowed a choice of accounting treatments (again, an example of accounting judgment being allowed). Despite eventually conceding that the profit should have been deferred and amortised, the company argued that no retrospective adjustment to the financial statements was necessary as the amount involved was not material, being equal to 3 percent of annual profit after tax. The materiality threshold factor should be highlighted as earnings manipulation can be achieved through a series of techniques that are individually of low value, thus slipping under the auditors' radar, but which in aggregate have a material impact on the financial statements.

In practice, schemes involving manipulation in more than one area of financial statements are common, supporting the theory that a fraud can itself serve as a catalyst for further fraud. The investigation of the Eastern European entity found six separate areas of the financial statements with questionable transactions which collectively were characterised as a systematic scheme to artificially inflate the company's profits. In another case, this time in the US, a suspicion of earnings management noted by an analyst found inappropriate accounting treatment of transactions in several areas of a company's financial statements, including classification of expenses as restructuring costs (thus appearing below the operating profit line) as well as numerous revenue manipulation schemes.

What are some signs that the line between legitimate and fraudulent earnings management has been crossed? GAAP considerations aside, a crucial red flag can be any sign of deliberate efforts by management to meet specific earnings objectives, particularly where these result in personal gain. In fact, drawing upon the fraud triangle mentioned above, motives can add significant weight and context when weighing up the legitimacy of the accounting treatment of transactions. In the case of the Eastern European entity, the investigation arose in the context of a joint venture dispute. An arbitral panel had been appointed to resolve a dispute between the owner-manager of the company and its joint venture partner, a Western European investor. The owner exercised a put option pursuant to which the investor was to acquire the remaining 51 percent stake. The price, payable to the owner, was to be determined by a formula based on the company's profits in a particular year. Ultimately, the manipulation of profits was found to be to so extensive that the price payable by the investor was reduced by more than 90 percent. In the

case of the US company, the senior management apparently responsible for the fraudulent accounting had collected significant performance-related bonuses over several years.

An effective internal control environment and internal audit function may reduce the risk of fraud but unfortunately cannot entirely eliminate it. Whilst true that the majority of incidents of fraudulent accounting are disclosed by a whistleblower, a heightened level of professional scepticism will always assist in identifying improper activities. Any signs of management override, perhaps evidenced by substantial volumes of journal entries processed at year-end, or collusion among executive ranks, can be red flags.

Suspicion of improper accounting should be raised with your company's lawyers in the first instance to preserve legal privilege in the event things ever end up in court, and any accounting investigations are often best handled by an independent specialist firm rather than the company's own auditors, thus deploying clear independence and avoiding any conflict of interests. ■