PacificCPE

Methods of Creative Accounting and Fraud

Course #2121A

Accounting

2 Credit Hours

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METHODS OF CREATIVE ACCOUNTING AND FRAUD

Flexibility in accounting opens the door for many different methods of creative accounting. This course covers five main strategies used by the creative accountant. In addition, special cases of fraud are examined, including the misappropriation of inventory, cash and assets, as well as the invention of fictitious transactions and businesses.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Methods of Creative Accounting and Fraud

Study the course materials from pages 1 to 34
Complete the review questions at the end of each chapter
Answer the exam questions 1 to 10

Objectives:

- To identify various creative accounting strategies and fraud methodologies

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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METHODS OF CREATIVE ACCOUNTING AND FRAUD

Course Objectives

After completing this course, you should be able to:

- Identify various creative accounting strategies and fraud methodologies.

INTRODUCTION

There are innumerable different methods of creative accounting. These arise because of the inherent flexibility within accounting. Each set of accounts consists of a myriad of different items of income, expenses, assets, liabilities and equities. For each different item there will be an accounting policy. As there are many accounting policies the opportunity arises to adapt and alter accounting policies so as to change the reported accounting figures. Indeed, one easy way to confuse investors is to continually change your results. As Robert Townsend (1970, p. 89) states: 'The easiest way to do a snow job on investors (or on yourself) is to change one factor in accounting each month. Then you can say, "It's not comparable with last month or last year and we can't really draw any conclusion from the figures".' The consistency concept limits but does not curtail companies' ability to do this. In the USA, WorldCom, which collapsed in 2002, was accused of repeatedly revising and restating its accounts. It was a pioneer of what was called proforma accounting.

The three main financial statements in a company's accounts are the income statement (also known as the profit and loss account), the balance sheet (also known as the statement of financial position) and the cash flow statement. In each of the three statements there will be different objectives for the creative accountant. In the income statement the main aim is usually to alter the profit figure. If the aim is (as is most common) to inflate profit, then incomes will be increased and expenses decreased. If profit is to be reduced then income needs to be decreased and expenses increased. In the balance sheet, the usual aim will be to increase the company's net worth. This can be done by increasing assets and decreasing liabilities. Finally, in the cash flow statement the aim will generally be to increase operating cash flow at the expense of other cash flows. In a sense, creative cash flow accounting is more difficult to achieve than creative profit creation. Cash is harder to manufacture than profit. As UBS Phillips & Drew (1991, p. 1) state: 'CASH IS KING. In the end, investment and accounting all come back to cash. Whereas "manufacturing" profits is relatively easy, cash flow is the most difficult parameter to adjust in a company's accounts. Indeed, tracing cash movements in a company can often lead to the identification of unusual accounting practices.'

I explore below some of the main methods by which these statements can be massaged. However, it should be stressed that the aim of the creative accountant is to adjust the accounts without the investors noticing. For if the stock market detects creative accounting practices then it will adjust the share price accordingly and the creative accountant's efforts will have been in vain. To indulge in creative accounting successfully, the creative accountant will also have to either hoodwink the auditors or persuade them

that the accounting practices are acceptable. Inevitably, therefore, the creative accounting policies used by companies are often subtle, sometimes very complex and hard to detect. The methods given in this course are thus generally simplified. In practice, the actual methods used, although following the same general principles, will be more complex. They are often by their very nature difficult to detect and decipher. After looking at the various methods of creative accounting, I will present a simple example which illustrates some of the creative accounting techniques. I will then look at some types of fraud. In many cases, fraud can be a continuation of creative accounting. However, it is interesting to consider separately two special aspects: the creation of fictitious entries and the misappropriation of assets. As with creative accounting, there are numerous different potential frauds.

Before looking at the actual methods the basic principles of what the creative accountant is trying to achieve will be examined. Then I will discuss how the basic technical nature of accounting helps the creative accounting process.

BASIC PRINCIPLES

Overall, the basic principles of creative accounting involve the three main financial statements. There are, as we can see from Figure 1, five main strategies.

FIGURE 1 CREATIVE ACCOUNTING STRATEGIES

1. Increase income

   One way of increasing profit. Under this strategy, sales or other income is increased.

2. Decrease expenses

   This is the second way of increasing profit. There are two main sub-strategies:

   2A. Just decrease expenses.

   2B. Decrease expenses and increase assets at the same time.

3. Increase assets

   One way of increasing the net worth of the company.

4. Decrease liabilities

   A second way of increasing the net worth of the company.

5. Increase cash flow

   Either by increasing cash operating income or decreasing cash operating expenses.

The first two strategies aim to increase the profit in the income statement. This can be done either by

increasing income or by decreasing expenses. For most companies, sales are the biggest source of income. So focusing on increasing sales is a common creative accounting strategy. However, there are other sorts of income, such as investment income, which also may be manipulated. The two main methods of reducing expenses are either by utilising provisions or by capitalising expenses (making them assets). Strategies three and four focus on the balance sheet. The third strategy is to boost assets, thus strengthening and increasing the company's net worth. The fourth strategy has the same effect; however, here we focus on reducing the liabilities. Finally, the fifth strategy is to increase cash flow. As it is almost impossible to increase cash per se (you either have it or you don't), this strategy is more about timing or presentation. There may be efforts made to accelerate the collection of the cash, which may mean collecting less cash now rather than more cash later. Alternatively, it will focus on increasing operating cash flow, which is the key cash flow for analysts. This is generally by trying to classify non-operating cash inflows as operating cash inflows and operating expenses as non-operating expenses.

NATURE OF ACCOUNTING

Most people, apart from accountants, are unaware that at the heart of accounting is an accounting equation. This stems from the basic symmetry in accounting in which the debits equal the credits. In effect, in accounting terminology debits equal credits. Debits are expenses and assets and credits are incomes, liabilities and capital. This can be expressed in two ways. The first is set out below.

DEBITS	**= CREDITS**
Assets and Expenses	= Income and Liabilities and Capital

Every accounting transaction has a debit and a credit. So if a business sells £100 worth of goods this results in a debit and a credit. In this case, the cash which is an asset (a debit) will increase and be matched by sales of £100 which are an income (a corresponding credit).

So how does this basic symmetry help the creative accountant? The key is that it is easy to change the basic elements of the accounting equation. Thus, if we classify expenses as assets the books will still balance. Alternatively, if we record liabilities as income the books will still balance. The basic nature of accounting thus facilitates creative accounting. Furthermore, in cases of fraud, fictitious transactions will still have their debits and credits (albeit non-existent in this case).

METHODS OF CREATIVE ACCOUNTING

We will now discuss some of the main methods of creative accounting. The five main strategies will be discussed in turn. The aim is to present a flavour of creative accounting. The techniques used in practice will often be impossible to detect, even by experienced analysts.

Generally, the techniques presented here will be methods of creative accounting rather than fraud. However, the two often overlap. In essence, any method of creative accounting, if stretched to its absolute limit, would step outside the boundaries of the regulatory system. Clear cases of fraudulent methods will be highlighted. In addition, if any of a company's income or assets are misappropriated by