Creative Accounting, Fraud and International Accounting Scandals

Edited by

Michael John Jones

i.



	Contents	
	/ LOU	
Li	ist of Contributors	xvii
Pr	reface	xxiii
A	cknowledgements	XXV
PA	ART A	1
1		3
	Michael Jones 1.1 Introduction	3
	1.1 Introduction 1.2 Exploring the Terms	4
	1.2.1 Creative Accounting	4
	1.2.2 Fraud	7
	1.2.3 Other Terms	9
	1.3 Structure of the Book	11
	1.3.1 Increase Income	12
	1.3.2 Decrease Expenses	12
	1.3.3 Increase Assets	12
	1.3.4 Decrease Liabilities	12
	1.4 Conclusion	18
2	The Creative Accounting and Fraud Environment	21
	Michael Jones	•
	2.1 Introduction	21
	2.2 The Main Actors	22
	2.2.1 Managers	22
	2.2.2 Investment Analysts	24
	2.2.3 Regulators	24
	2.2.4 Auditors	25
	2.2.5 Shareholders	26
	2.2.6 Merchant Banks	26

.

A.

_R.' '

		2.2.7 Other Users	27
		2.2.8 Legal Authorities	27
	2.3	Effective Corporate Governance	28
		2.3.1 Effective Internal Controls	28
		2.3.2 Division of the Responsibility between Chief Executive	
		and Chairman	28
		2.3.3 Audit Committee	28
		2.3.4 Independent Board of Directors	28
	2.4	Economic Environment	28
	2.5	Conclusion	29
3	Mot	ivations to Indulge in Creative Accounting and Fraud	31
	Mich	ael Jones	
	3.1	Introduction	31
		3.1.1 Personal Incentives	33
		3.1.2 Market Expectations	34
		3.1.3 Special Circumstances	36
		3.1.4 Cover-up Fraud	39
	3.2	Conclusion	39
4	Met	hods of Creative Accounting and Fraud	43
	Micl	ael Jones	
		Introduction	43
		Basic Principles	44
		Nature of Accounting	45
	4.4	6	45
		4.4.1 Strategy 1: Increase Income	46
		4.4.2 Strategy 2: Decrease Expenses	48
		4.4.3 Strategy 3: Increase Assets	56
		4.4.4 Strategy 4: Decrease Liabilities	58
		4.4.5 Strategy 5: Increase Operating Cash Flow	60
		Simple Numerical Example	61
	4.6	Fraud	62
		4.6.1 Misappropriation of Assets	64
	•	4.6.2 Fictitious Transactions	65
	4.7	Conclusion	67
5		lence for Creative Accounting and Fraud	69
		ael Jones	
	5.1	Introduction	69
	5.2	The Descriptive Studies	69
		5.2.1 Ian Griffiths, Creative Accounting (1986)	71
		5.2.2 County Natwest WoodMac, <i>Company Pathology</i> (1991)	72
		5.2.3 UBS Phillips & Drew, Accounting for Growth (1991)	73
		5.2.4 Trevor Pijper, Creative Accounting (1993)	76

		5.2.5	Frank Clarke, Graeme Dean and Kyle Oliver, Corporate	
			Collapse: Accounting, Regulatory and Ethical Failure (2003, first	
		576	issued 1997)	77
		5.2.0	Frank Clarke and Graeme Dean, <i>Indecent Disclosure: Gilding the</i>	78
		527	Corporate Lily (2007) McBarnet and Whelan, Creative Accounting and the Cross-eyed	/0
		5.4.1	Javelin Thrower (1999)	78
		528	Charles Mulford and Eugene Comiskey, <i>The Financial Numbers</i>	78
		5.2.0	Game (2002)	79
		5.2.9	Beasley, Carcello and Hermanson, Fraudulent Financial Report-	12
			ing 1987–1997: An Analysis of U.S. Public Companies (1999)	81
		5.2.10	Joseph Wells, Principles of Fraud Examination (2005)	82
	5.3	The Sta	atistical Studies	84
		5.3.1	Earnings Management Studies	84
	5.4	Conclu	sion	93
,	Ŧ			0.
6		ression ael Jone	Management	97
	6.1	Introdu		· 97
	0.1		Accounting Narratives	97 97
			Graphs	102
	6.2	Conclu	•	111
		00110		
7			Long View: Accounting Scandals over Time	115
		ael Jone		
	7.1	Introdu		115
			Ancient and Medieval	117
			Seventeenth and Eighteenth Centuries	118
			Nineteenth Century	119
			Twentieth Century: Before Second World War	122
	7 7	7.1.5 Conclu	Twentieth Century: 19451980s	127
	7.2	Conclu	ISIOII	132
PA	RT E	3		135
8	Acc	ounting	Scandals in Australia since the Late 1980s	137
			negie and Brendan T. O'Connell	
	8.1	Introdu	iction	137
	8.2	Overvi	ew of Accounting Scandals during and since the 1890s	138
	8.3	Case S	tudies of Accounting Scandals since the Late 1980s	141
		8.3.1	Adelaide Steamship	142
			Bond Corporation	143
			Harris Scarfe	145
		8.3.4	One.Tel	146

	8.4	HIH Insurance	147	
		8.4.1 Background	148	
		8.4.2 Why did HIH Collapse?	149	
		8.4.3 Accounting Issues	150	
		8.4.4 Legal Outcomes Arising from the HIH Collapse	152	
	8.5	Corporate Governance Reforms Following the		
		Accounting Scandals of the Early 2000s	155	
	8.6	Conclusion	156	
9	Corp	orate Accounting Scandals in China	163	
		rine Huirong Chen, Yuanyuan Hu and Jason Zezhong Xiao		
	9.1	Introduction	163	
	9.2	Summary of Corporate Scandals	164	
		9.2.1 Shenzhen Yuanye	164	
		9.2.2 Great Wall Fund Raising	166	
		9.2.3 Hongguang	167	
		9.2.4 Daqing Lianyi	168	
		9.2.5 Kangsai Group	169	
		9.2.6 Lantian Gufen	170	
	9.3	A Case in Depth – Zhengzhou Baiwen	172	
		9.3.1 Background	172	
		9.3.2 Themes of the Scandal	174	
		9.3.3 Who is to Blame?	176	
		9.3.4 Consequences of the Baiwen Scandal	178	
		9.3.5 Aftermath	179	
	9.4	Conclusion	180	
10	Acco	unting Scandals in Germany	185	
10		uniting Scunduls in Germany	100	
		Introduction	185	
		Accounting Scandals Between 1985 and 2006	186	
		10.2.1 Co op AG (1988)	186	
		10.2.2 Balsam AG (1994)	187	
		10.2.3 Bremer Vulkan Verbund AG (1995)	189	
		10.2.4 Philipp Holzmann AG (1999)	191	
	10.3	Most Important Cases: Flowtex and Comroad	193	
		10.3.1 Flowtex Gmbh & Co. KG (2000)	193	
		10.3.2 ComRoad AG (2001)	195	
	10.4	Accounting Scandals and Regulatory Responses	200	
	10.5	· · · ·		
		Panel 2005–2006	202	
	10.6	Conclusion	208	

		Conte	nts xi
11	Crea	tive Accounting and Fraud in Greece	211
		ge Kontos, Maria Krambia-Kapardis and Nikolaos Milonas	
	-	Introduction	211
	11.2	Two Accounting Scandals	213
		11.2.1 ETBA Finance	213
		11.2.2 Dynamic Life	217
	11.3	The Bank of Crete Scandal	220
		11.3.1 Koskotas's Employment with the Bank of Crete	221
		11.3.2 The Accounting Information Systems of the Time	223
		11.3.3 The Economic Environment at that Time	225
	11.4	The Aftermath	229
	11.5	Conclusions	231
12	Corp	oorate Creative Accounting in India: Extent and Consequences	233
	Bhaba	atosh Banerjee	
	12.1	Introduction	233
	12.2	Some Examples of Creative Accounting in India	234
	12.3	Some Important Corporate Cases in India	239
	12.4	The Satyam Computer Services Ltd Scandal (2009)	- 240
		12.4.1 Background	240
		12.4.2 Satyam: A Global Organisation	240
		12.4.3 Alleged Possible Processes and their Impact	241
		12.4.4 Good Guy, Bad Choices	243
		12.4.5 Role of the Auditors	243
		12.4.6 Institution of Legal Proceedings	245
		12.4.7 Salvaging Satyam	245
		12.4.8 Rebuilding the Corporate Image	246
		12.4.9 Some Antidotes	247
	12.5	Aftermath	247
		12.5.1 Changes in the Companies Act	247
		12.5.2 Measures Taken by the SEBI	248
		12.5.3 Prudential Norms of the RBI	249
	12.6	Conclusion	250
	12.7 •	Acknowledgements	251
13		tive Accounting and Accounting Scandals in Italy	253
		ea Melis	
	13.1	Introduction	253
	13.2	Creative Accounting Practices in Italy: A Case	
		Study Analysis	255
		13.2.1 The Choice of Consolidation Technique	255
		13.2.2 The Accounting of Stock Options	256
		13.2.3 The Accounting of 'Creative Gains' in Football Club	
		Companies	257

	13.3	The M	ost Important Accounting Fraud in Italy: The Parmalat Case	259
		13.3.1	Parmalat: Was it a Case of Creative Accounting or of False	
			Accounting?	260
		13.3.2	Key Accounting Issues at Parmalat: Some Examples of the	
			Accounting Fraud	261
			The Role of Corporate Governance Actors	265
		13.3.4	The Role of Information Demand-side Actors: Institutional	
			Investors, Financial Analysts and Banks	271
	13.4		termath of the Parmalat Scandal and its	
		-	on Business and Society	272
	13.5	Conclu	ision	274
14			counting and Accounting Scandals in Japan	279
	•	uki Suda		270
		Introdu		279
	14.2		nting Regulations and Standards in Japan	280
			Accounting Regulations	280
	110		Accounting Standards	280
			History of Accounting Scandals Before the 1980s	281
	14.4		Types of Accounting Scandal Post-1980s	283
			Accounting Scandal to Maintain High Share Prices	285
			Accounting Scandal Related to Contracts	289
	145		Accounting Scandal to Avoid Bankruptcy	292
	14.5		quences of the Accounting Scandals	296
		14.5.1	Revision of Accounting Standards for Consolidated Financial	200
		1450	Statements	296
			Reorganization of Audit Firms	296
	140		Establishing Internal Control Systems	297
	14.0	Conclu	ision	298
15			counting Scandals in the Netherlands	305
		Langend	5	
		Introdu		305
	15.2		Minor Accounting Scandals	307
			Creative Accounting at Rijn-Schelde-Verolme (RSV)	307
	150		Creative Accounting at Fokker	309
	15.3	Royal .		310
			Consolidation of Joint Ventures at Royal Ahold	310
		15.3.2	6	311
		15.3.3	Consolidation Accounting under US GAAP	311
		15.3.4	The Control and Side Letters	312
		15.3.5	Accounting for Vendor Allowances at US Foodservice (USF)	315
		15.3.6	Proper Accounting Treatment Vendor Allowances	315
		15.3.7	Measures Taken by Royal Ahold after Discovering the Fraud	318

, .

.

			Contents	xiii
		15.3.8	Acquisition Accounting	319
			Reserves, Allowances and Provisions	320
			Lease Accounting	320
	15.4	Conclu	-	320
16	Crea	tive Acc	ounting and Financial Scandals in Spain	325
		s Carrera		
	16.1	Introdu	iction	325
	16.2	Accour	nting Scandals in Spain Since the 1980s	326
			The Banking Sector	327
		16.2.2	Investment Service Firms	330
		16.2.3	The Real Estate Sector: The Case of PSV and IGS	332
	16.3	Investn	nents in Stamps: The Latest Series of Financial Scandals in the	
		Countr	y. Afinsa and Fórum Filatélico	333
		16.3.1	Background of the Cases of Afinsa and Fórum Filatélico	334
		16.3.2	The Nature of the Businesses and the Accounting for Invest-	
			ment Contracts	335
			The Suppliers	337
		16.3.4	Valuation of Stamps	339
		16.3.5	Reflections on the Scandal	340
		16.3.6	Where were the Auditors?	341
		16.3.7	Was it a Surprise?	341
			Consequences of the Scandal	343
	16.4	The Af	termath of the Scandals	344
	16.5	Conclu	ision ,	346
17	Acco	unting S	Scandals in Sweden – A Long Tradition	359
	Gunn	ar Rimme	el and Kristina Jonäll	
	17.1	Introdu	action	359
	17.2	Fermer	nta and Prosolvia: Swedish Stock Market	
		Darling	gs	360
		17.2.1	Fermenta – 1980s Biotech Company's Accounting Errors	360
		17.2.2	Prosolvia – 1990s Experts in Simulating Virtual Reality?	363
	•		Reconstruction of Ownership	364
		17.2.4	Fictitious Invoices, Invented Agreements and Premature	
			Income Recognition	364
			Insider Trading	365
	17.3		candals in Multinationals that Dominated	
			edish Media	365
			ABB – Shaken and Stirred	365
			Skandia – A Shooting Star Turns into a White Dwarf	368
	17.4	Conclu	isions	373

18	Crea	tive Accounting – The UK Experience	379
	David	Gwilliam and Richard H.G. Jackson	
	18.1	Introduction	379
	18.2	Historical Background	381
	18.3	Some Recent Accounting Scandals	382
		18.3.1 Bank of Credit and Commerce International (BCCI)	383
		18.3.2 The Mirror Group	385
	18.4	Polly Peck	386
		18.4.1 Meyna	389
		18.4.2 Vestel	390
		18.4.3 Unipac	390
		18.4.4 Accounting Policies at Polly Peck	391
	18.5	The Immediate Aftermath	398
		18.5.1 Accounting Regulatory Change	398
		18.5.2 Governance and Enforcement	400
	18.6	Subsequent Developments	400
		Conclusions	402
		Acknowledgements	404
19	Crea	tive Accounting and Accounting Scandals in the USA	407
		es W. Mulford and Eugene E. Comiskey	
		Introduction	407
		Scandals since the 1990s	410
		19.2.1 Premature or Fictitious Revenue Recognition	410
		19.2.2 Capitalized Costs and/or Extended Amortization Periods	412
		19.2.3 Overstated Assets and/or Understated Liabilities	416
		19.2.4 Other Creative Accounting Practices	416
	193	Enron and Worldcom	419
	17.0	19.3.1 Enron Corp.	419
		19.3.2 WorldCom, Inc.	421
	19.4	Aftermath of the Scandals	423
20	Bank	Failures and Accounting During the Financial Crisis	
		08–2009	425
		n D. Norton	
		Introduction	425
	20.2		428
	20.2	20.2.1 Kaupthing Bank	428
		20.2.2 Northern Rock	429
	20.3		430
	20.5	20.3.1 Sub-prime Lending	430
		20.3.2 Types of Mortgage	430
		20.3.3 Economic Downturn and Rising Unemployment	432
	20.4	Financial Instruments Associated with	432
	<i>4</i> 0.4	the Credit Crunch	432
			432

.

		20.4.1	Collateralised Debt Obligations (CDOs)	433
		20.4.2	Credit Default Swaps (CDS)	433
		20.4.3	Collateralised Mortgage Obligations (CMOs)	434
		20.4.4	Securitisation and Off-balance Sheet Financing	434
		20.4.5	Repurchase agreements or 'repos'	436
	20.5	Creativ	e Accounting in the Banking Sector	437
		20.5.1	Loan-loss Allowances	437
		20.5.2	Adjustment of Reporting Dates	437
		20.5.3	Enhancing Profits through Disposals of Assets	438
		20.5.4	Lawful Adjustments to Composition of 'Level 3' Assets in	
			Banks' Balance Sheets	438
		20.5.5	Decline in Value of Outstanding Debt	439
	20.6	Lehma	n's, Madoff and Bear Stearns;	
		Failure	s and Consequences	440
		20.6.1	Lehman Brothers	440
		20.6.2	Bernard Madoff	445
		20.6.3	Bear Stearns	448
	20.7	Conclu	ision	450
PART C 4				
21	21 Identifying Some Themes			455
	Michael Jones			
	21.1	Introdu	iction	455
	21.2	Some 7	Themes	455
		21.2.1	Background	455
			Creative Accounting or Fraud	459
	21.3	The M	ajor Methods Used	460
		21.3.1	Strategy 1: Increasing Income	461
		21.3.2	Strategy 2: Decreasing Expenses	462
		21.3.3	Strategy 3: Increasing Assets	464
		21.3.4	Strategy 4: Decreasing Liabilities	465
		21.3.5	Other Methods of Creative Accounting	466
	21.4	Metho	ds of Fraud	467
	21.5	Incenti	ves for Creative Accounting and Fraud	471
	21.6	Overst	rong Personalities	473
	21.7	Failure	e of Internal Controls	474
	21.8	Failure	e of External Auditors	475
	21.9	Conclu	ision	477
			`с	
22		-	of Accounting Scandals and Creative Accounting	479
		ael Jones		
		Introdu		479
	22.2	Short-1	term Immediate Effects	479

Ind	ex			535
Ap	pendix	-	habetical List of Most Important Accounting Scandals oss 12 Countries and Beyond since about 1980	519
Ap	pendix		conological List of Major Instances of Accounting Issues coss 12 Countries and Beyond	509
	23.5	Conclu	sion	506
		Progno		505
			Fraud	501
		23.3.2	Factors Reducing the Potential for Creative Accounting and	
		23.3.1	Factors Increasing the Possibilities of Creative Accounting and Fraud	499
	23.3		s for the Future	499
			tic Analysis	496
	23.1	Overvi	ew	493
	Micha	el Jones		
23	Conc	lusion –	Looking Backwards and Forwards	493
	22.5	Conclu	sion	490
			ative Effects	487
		22.3.1	One-off Regulatory Responses	484
	22.3	Long-to	erm Effects	484
		22.2.2	Outsiders	481
		22.2.1	Insiders	480

. .

.

•

,