KNOW YOUR COMPANY – IDENTIFYING CREATIVE ACCOUNTING AND FINANCIAL FRAUD IN CREDIT RISK MANAGEMENT

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1. Introduction & Relevance

Although banks have carried out lending activities for centuries with traditional credit risk assessment methods, the scientific art of credit risk management evolved only after the introduction of Basel I. Basel I assessed capital in relation to credit risk (risk of loss due to failure of a counterparty to meet its obligations); hence subsequently banks themselves developed techniques to improve risk management and internal capital measures to control and manage such risks.

Most credit models that were in place used internal grading scales to assist the credit assessment process. Facility grading scale covers the processes and methodologies that enable differentiation between relative credit risk and classify borrowers on a consistent basis. Since borrowers were grouped into broad fixed buckets reflecting a relative risk profile, these grading systems had dimensional scales that did not equate with statistical probability of an event occurring, thereby provided little insight to comparison of risk profiles.

As we are aware regulatory capital under Basel I did not provide a fair and comparative assessment of risk, leaving highly rated corporates with low probability of default treated in the same manner as poorly rated corporates or personal borrowers. However Basel II, introduced in 2004, covered this weakness and is expected to speed the adoption of better credit risk management techniques and further evolution of risk measurement.

Two options detailed in Basel II in calculating credit risk are the Standardized Approach and Internal Rating Based Approach (IRB). Standardised Approach uses borrower’s rating assessed by External Rating agencies whereas IRB uses bank’s estimate of borrower’s risk. CBSL has announced that Sri Lanka would initially use the Standardized Approach. However, international banks are expected to use advanced IRB Approach in their global operations once their internal rating process is approved by the applicable regulators.

In Sri Lanka, where we are in the early development stage of external rating, it is very likely that most of the exposure to corporate sector is 100% risk weighted under the Standardised Approach. Given this situation, in going forward, there would be a tendency to improve Credit Risk Management process among banks operating in Sri Lanka and move towards IRB Approach to take advantage of low capital requirement applicable to high quality assets.

Given these developments, the need for a more detailed, accurate and consistent credit risk model and internal grading framework that better evaluates related risks has arisen. The objective is to introduce improved risk rating tools for internal capital allocation (economic capital concept) allowing greater ability to price, measure and manage portfolio risk and to optimize return in relation to risk. It is expected that these procedures would identify each borrowing group, the key components of its risk profiles, as listed in Basel II, ie. Probability of Default, Loss Given Default, Exposure at Default and Effective Monitoring.

In this scenario, lender's ability to assess corporate borrowers' financials and proactive identification of risks has become an important part in credit risk modeling in assigning of applicable risk grades.

Subsequent discussions in this paper will focus on key points that assist lenders to proactively identify financial risks which are key components in modern Credit Risk Model. In doing so, the lender should be familiar with various accounting tricks (Creative Accounting) being used by some corporates: since an awareness of these gimmicks and having a healthy skepticism before carrying out financial analysis are vital for risk identification.

2. Creative Accounting

Creative Accounting refers to accounting practices that deviate from standard accounting practices. They are characterized by excessive complications and the use of novel ways of characterizing income, assets or liabilities. This results in financial reports that are not dull, but have all the complications of an exciting novel; hence the appellation "creative" is what constitutes its hallmark. Sometimes the words "innovative" or "aggressive" are also used to describe its subtle employment.

Creative Accounting occurs at companies of all sizes, quoted or unquoted and in well known global corporates as well. These tricks are intentional to distort a company's reported financial performance and condition so that it will provide a more attractive outlook to the lenders or investors.

3. Common Techniques of Creative Accounting

3.1 Income Statement

Howard Schilit, in his book Financial Shenanigans has stated that Centre for Financial Research and Analysis (CFRA) has identified thirty such techniques (grouped into seven categories) used by corporates to trick bankers and investors, as detailed below

3.1.1 Recording Revenue Too Soon or of Questionable Quality

- Recording revenue when future services remain to be provided
- Recording revenue before shipment or before the customer's unconditional acceptance
- Recording revenue even though the customer is not obligated to pay
- Selling to an affiliated party
- Giving the customer something of value as a quid pro quo

- Grossing up revenue

3.1.2 Recording Bogus Revenue

- Recording sales that lack economic substance
- Recording cash received in lending transactions as revenue
- Recording investment income as revenue
- Recording as revenue supplier rebates tied to future required purchase
- Releasing revenue that was improperly held back before a merger

3.1.3 Boosting Income with One-Time Gains

- Boosting profits by selling undervalued assets
- Including investment income or gains as part of revenue
- Reporting investment income or gains as a reduction in operating expenses
- Creating income by reclassification of balance sheet accounts.

3.1.4 Shifting Current Expenses to a Later or Earlier Period

- Capitalizing normal operating costs, particularly if recently changed from expensing
- Changing accounting policies and shifting current expenses to an earlier period
- Amortizing costs too slowly
- Failing to write down or write off impaired assets
- Reducing asset reserves

3.1.5 Failing to Record or Improperly Reducing Liabilities

- Failing to record expenses and related liabilities when future obligations remain
- Reducing liabilities by changing accounting assumptions
- Releasing questionable reserves into income
- Creating sham rebates
- Recording revenue when cash is received, even though future obligations remain

3.1.6 Shifting Current Revenue to a Later Period

- Creating reserves and releasing them into income in a later period
- Improperly holding back revenue just before an acquisition closes

3.1.7 Shifting Future Expenses to the current Period as a Special Charge

- Improperly inflating amount included in a special chart
- Improperly writing off in-process R&D costs from an acquisition
- Accelerating discretionary expenses into current period

We will be discussing a couple of these techniques in the latter part of the paper.

3.2 On Balance Sheet

Some Analysts refer to balance sheet as a swimsuit. “What it reveals is interesting, what it conceals is vital”. It is interesting to find out whether the company is hiding vital or material information using the balance sheet. Interestingly, Arthur Levitt, former chairman of the US Securities and Exchange Commission, identified five of the more popular creative accounting techniques used to distort balance sheets, ie. “big bath” accounting, creative acquisition accounting, “cookie jar reserves,” “immaterial” misapplications of accounting principles, and the premature recognition of revenue.

3.2.1 “Big Bath” Charges

“Big Bath” hypothesis suggests that management will report additional losses in bad years in the hope that, by taking all available losses at one time, they will “clear the decks” once and for all. Companies sometimes set up large charges associated with restructuring. These charges help companies “clean up” their balance sheet,giving them a so-called “big bath.”

Why are companies tempted to overstate these charges? When earnings take a major hit, the theory goes - analysts will look beyond a one-time loss and focus only on future earnings. Consequently, these charges are “conservatively estimated” with extra cushioning. The so-called conservative estimates then miraculously end up as income when future earnings fall short.

3.2.2 Creative Acquisition Accounting

In recent years, most industries have been rationalized through consolidations, acquisitions and spin-offs. Some acquirers, particularly those using stock as an acquisition currency, have used this environment as an opportunity to engage in “Creative Acquisition Accounting”

In the purchase price allocation procedures, some companies classify a large portion of the acquisition price as “in-process” Research and Development, which can be written off in a “one-time” charge – removing any future earnings drag.

Sometimes, large liabilities for future operating expenses are created to protect future earnings.

3.2.3 Miscellaneous “Cookie Jar Reserves”

A third trick played by some companies is using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in “cookie jars” during the good times and reach into them when needed in the bad times.

3.2.4 “Materiality”

Some companies misuse the concept of materiality. They “intentionally” record errors within a defined percentage ceiling. This is justified on the basis that the effect on the profit is too small to matter. When the management is questioned about these clear violations of accounting principles, they answer sheepishly, “It doesn’t matter. It’s immaterial.” A Fortune 500 company had recorded a significant accounting error, though the auditors highlighted it. But they still used a materiality ceiling of six percent earnings to justify the error. Materiality is not a bright line cut-off of three or five percent. It requires consideration of all relevant factors that could impact an investor’s or lender’s decisions.

3.2.5 Revenue Recognition (Income Smoothing)

Some companies try to boost earnings by manipulating the recognition of revenue which also manipulates the balance sheet. Some firms reduce revenue in good years (defer gains or recognize losses) and inflate earnings in bad years (recognize gains or defer losses) in order to report stable earnings, which is known as “smoothing”.

3.3 Off Balance Sheet Items

The last few years have seen a number of attempts by companies to remove assets and liabilities from balance sheets through transactions that may obscure the economic substance of the company’s financial position. There are three areas that warrant mention, each of which has the potential to obscure the extent of a company’s assets and liabilities.

3.3.1 Leasing Transactions

A company that owns an asset -say an aircraft- and finances that asset with debt, reports an asset (the aircraft) and a liability (the debt). Under existing accounting standards a company that operates the same asset under a lease structured as an operating lease reports neither the asset nor the liability. Imagine a balance sheet that presents an airline without any aircraft – not a faithful representation of economic reality!

This matter is being addressed internationally, and there is a distinct possibility that the companies will be required to recognize assets and related lease obligations for all leases, both finance and operating.

3.3.2 Securitisation Transactions

A company that transfers assets (like loans or credit-card balances) through a securitization transaction recognizes the transaction as a sale and removes the amounts from its balance sheet. Some securitizations are appropriately accounted for as sales, but many continue to expose the transferor to many of the significant risks and rewards inherent in the transferred assets and therefore should not be removed.

3.3.3 Creation Of Unconsolidated Entities

A company that transfers assets and liabilities to a subsidiary company must consolidate that subsidiary in the parent company's financial statements. However, in some cases (often involving the use of a Special Purpose Entity), the transferor may be able to escape the requirement to consolidate.

It should be noted that not all of the above tricks are illegal acts or violations of generally accepted accounting principles. What is important is to be aware of such practices and be alert to pick them when a borrowing proposal is submitted. Some of the cases, that are discussed later in this paper, shows how the corporates have used the above techniques to misguide their bankers/investors.

4. Addressing the Peril of Creative Accounting

Recent reports of high-profile company failures have cast the spotlight on creative accounting and renew the calls for published financial statements that show a full and accurate picture of a company's performance and position.

The recent technical rule changes by the regulators and standard setters (IAS, GAAP) has improved the transparency of financial statements and have gone a long way in addressing the creative accounting techniques addressed here. Developments in the International Standards – some finalized, others in-process (such as lease accounting referred to above) – will further close the gate for this form of manipulative accounting. Whilst tightening the technical rules does go a long way, it is not the only answer to this problem.

Accounting failures in large corporates have led some to question the thoroughness of audits. Too much reliance is placed on the auditors to uncover fraudulent practices of creative accounting. Although it is argued, auditors are the watchdogs and not the bloodhounds in the financial reporting process, they still have a major role to play to ensure that these misdeeds are minimized.

In this scenario, bankers should be aware that it is the management that is primarily responsible for the presentation of the financial statements. Hence it is not a bad idea to study why these companies do creative accounting and study the logic behind such requirement to identify possible candidates.

5. Why do the Companies use Creative Accounting

In some companies, managers' compensation is related to the company's performance. Hence, there is a tendency to inflate figures to obtain incentives such as stock options, bonuses, etc. A competitive structure that emphasizes bottom line creates an environment encouraging creative accounting. It can be a slight adjustment to improve the current assets (eg. re-classify a long term asset) to ensure a current ratio covenant is met so there will not be an interest rate increase on the borrowings or it can be a survival technique. Companies desperate to survive require desperate measures, sometimes Creative Accounting!

Flexibility offered to the managers in some accounting standards to select accounting methods (eg. depreciation, inventory valuation method) makes it easier for them to manipulate. This explains the importance of reading auditors explanatory notes in the accounts to find out accounting policies. However, it should be noted that only the annual accounts of publicly held companies are required to be audited, not the quarterly statements, leaving room for the management to doctor the figures.

Since we never know in advance which companies publish misleading information, it is prudent to be suspicious of all companies to detect early warning signs. Scultz has identified 3 such signs to identify possible candidates.

(i) Weak control environment (lack of competent internal auditor, lack of independent board members)

(ii) Management facing extreme competitive pressure

(iii) Management known or suspected of having questionable characters.

Bankers should be particularly alert for these signs in fast-growth companies, whose real growth is beginning to slow, the companies that are struggling to survive and newly formed companies

6. Financial Reporting System & Adjustments Required for Comparison

In an ideal scenario, users of financial statements should focus only on the bottom line, ie. Net Profits and Tangible Networth. If financials are comparable among companies, consistent and always reflect the economic position of the firm, analysis is straightforward. Unfortunately financial reporting system is far from perfect. Economic events and accounting entries do not correspond precisely. One example is the recognition of capital gains and losses only upon sale. Appreciation of a fixed asset, which took place over the past years, receives income statement recognition only in the year it was disposed. Long-lived assets are written down in the year of management choice. Further, many economic events do not get accounting recognition at all. For example, most contracts are not reflected in financials, when entered into, though it gives impact on operating and financial risks. As stated before, some companies do recognize leases and hedge arrangements in the financial statements but some disclose only by a footnote.

Hence it is important for the analyst to go through relevant notes and arrive at an adjusted set of financials. In the case of Balance sheet, it is appropriate to make adjustments to enhance its relevance such as adding off-balance sheet assets or liabilities and measuring all assets and liabilities at current value etc. Commitments and contingent liabilities need comparison with tangible net worth and company's cash flow.

Standard & Poor regularly identifies accounting areas that require analytical adjustments to enable a better evaluation of credit risk. Its December 2004 edition of the South and Southeast Asian Corporate Review highlighted several potential problems associated with comparing the financial analysis of firms adopting differing accounting practices. In determining the economic and financial health of banks' customers in comparison to a peer group, the points given below, represent some of the key areas in which current, flexible accounting standards might hinder effective analysis, especially on an international basis.

- Debt Like Obligations:

These are not regarded as debt in financial statements even though they may have a real call on cash at some stage in the future.

- Asset Retirement Obligations
- Take or Pay Contractual Payments
- Pension Liabilities
- Operating Leases
- Performance Guarantees or After Sale Obligations
- Potential Liabilities after Litigation

- Reported Earnings

Particular practices that companies might use to boost or smooth profits include:

- Different practices of Revenue Recognition
- Costing & Expenditure Capitalisation Policies
- One-time adjustments, eg. Asset Revaluation / Restructuring Charges

If customers adopt different accounting practices in these areas, it may have an effect on the ratios used in assessment. Hence, care should be taken to make the appropriate adjustments during analysis.

7. Earnings Power and Normalised Earnings

As is the case of book values in the Balance Sheet, reported Net Income requires adjustments for analysis purposes. Hence the objective is to measure operating results recorded as against 'Earning Power' of the firm. "Earning Power" represents the permanent net income of the company ignoring one-off temporary, non-revolving factors. However, given the practical difficulties in determining 'Earning Power' of a company, a process called 'normalisation' can be applied, where normal operating earning is estimated for each period. Normalisation of earnings consists mainly of removing nonrecurring items from reported income such as

- accounting changes
- realized capital gain or loss
- catastrophes such as natural disaster/accidents
- expenses on strikes, litigation etc

The above process would give a set of adjusted financials and the rationale for this process is the production of unbiased and comparable data set free of unusual items which is useful for credit decisions.

8. Quality of Earnings

The term 'Quality of Earnings" refers to the degree of conservatism in a company's reported earnings. In their book "The Analysis & Use of Financial Statements" White et al have discussed the following indicators of high earnings quality.

(i) conservative revenue recognition methods
(ii) bad debt reserves that are high relative to receivables
(iii) use of accelerated depreciation method and shorter lives
(iv) rapid write off of acquisition goodwill and intangibles
(v) minimal capitalization of interest and overhead
(vi) minimal capitalization of computer software cost
(vii) expensing of start-up costs of new operations
(viii) use of completed contract method of accounting for contracts
(ix) conservative assumptions used for employee benefit plans
(x) adequate provisions for lawsuits/contingencies
(xi) minimal use of off-balance sheet financing
(xii) absence of non recurring gains and non cash earnings
(xiii) clear and adequate disclosures

Above indicators tend to result in an understatement of net income through a combination of delayed income recognition and accelerated recognition of expenses. Companies with high earning quality are considered less risky. Any major deviation from above practices would lead to creative accounting which can be used to mislead lenders and investors.

A proper financial analysis in a credit proposition should focus on the adjusted balance sheet and normalized earnings statement rather than common P&L and Balance Sheet. Cash flow analysis is another critical area since it is subject to a lesser level of manipulation. Given the space constraints, importance of cash flow analysis in credit risk management is not iscussed in this paper but it should be noted that it is 'cash' that pays our debt, not accounting profits.

Having discussed various Creative Accounting techniques and the concepts of

"Adjusted Balance Sheet", "Normalized Income" and "Quality of Earnings" in evaluating financial statements, the remainder of this paper will focus on few classic international and local cases where Creative Accounting has been used to mislead bankers and investors. What is important is to learn from past mistakes and to ensure that such mistakes are not repeated.

9. Some Recent Creative Accounting Cases

- A highflying technology company in the USA, 'Datapoint Corporation' recorded revenue when products were shipped to distributors. When distributors had low sales, Datapoint was asked to curtail shipping volumes. Some time later, distributors warehouses were overflowing, due to lack of orders, hence, Datapoint was asked to suspend all shipments. This led to a problem as Datapoint needed a place to ship its products to record revenue. Company had an answer. They simply leased a warehouse and shipped goods there. (i.e. Trick No.3.1.1 recording revenue of questionable quality).

- Sales to an affiliated party raises concerns on the quality of revenue. Sales to a vendor, business partner raises doubt as to whether the transaction can be considered 'at arms length'. Similarly doubt arises when a company sells to a strategic partner. A Sri Lankan company (subsidiary of an international group) manufacturing garment hangers had 80% of their sales recorded to the parent company in the USA. Parent took number of months to settle their dues inflating the local company debtors leaving the lenders to finance debts and investment of USA parent as well.

- Recording sales that lack economic substance is another common trick to record bogus revenue. A side agreement may allow customers to return goods at any time for a full refund. A software company had entered into such arrangements to 'park' software licences with resellers and thereby accelerate revenue recognition.

- Recording cash received in lending transactions as revenue is another trick used by some companies. A bank loan is a liability which must be paid whereas money received from the customer in return for service rendered is for the company to keep. Xerox Ltd unfortunately had difficulties in understanding the distinction. In 2001, Wall Street Journal reported a variety of tricks used by Xerox, such as

- recording sales from sale of "future" receivables to a lender (factoring)
- improper recognition of revenue from its leasing operations by booking up-front the lease payments for future supplies.
- failure to write-off mounting bad debts

- Boston Chicken which was referred as the next McDonalds in 1993, raised USD1Bn from stocks through an IPO arranged by Merril Lynch. Despite 3 years of operation, company's core business (restaurant sales and franchise fees) was losing money. All profits came from interest income from franchise, to which the company had lent money. Most of the franchises had affiliations with executives of the company. Such interest income was bundled with restaurant sales making it difficult for analysts to detect the problem. Company eventually filed for bankruptcy in 1998 and ironically, McDonalds bought some of its assets later.

- Boosting stocks and debtors to obtain funds from banks is another trick. Allied Crude Vegetable Oil Refining Corporation devised an ingenious way of overstating the company's inventory of salad oil. It filled many of the company's vats with water, adding only a layer of oil on top. Underground pipes connected the vats, so that the layer of oil could be shifted across the vats as needed during inventory inspection by lenders. For many years financiers loaned the company and each loan was covered by a pledge of oil stock as collateral. When company collapsed after a decade, auditors discovered that salad oil tanks were empty and banks lost over USD175Mn.

- Disk drive manufacturer Miniscribe went for a debt offering to expand its growth and auditors (one of the top 3 international firms) signed off the financial reports. Offering was a huge success. However reported profits were completely bogus and auditors had been tricked. One such trick used against auditors counting inventory was to fill the boxes with bricks. Since auditors failed to open those boxes, they had no idea of the quality of stocks.

- In Sri Lanka too we have similar cases. A group of companies which had two of their manufacturing entities registered under different names, used the same premises. These two companies were audited by two different firms. Over several years, the group had systematically overstated their stocks and auditors could not identify the mismatch as each auditor was told that stocks that they were verifying belonged to the company that was being audited. There were sizeable inter-company sales figures and inter-company borrowings as well. Some banks could not identify the situation till the group had cash flow difficulties in servicing interest. Final stock taking confirmed an excess unsupported short term borrowing in excess of LKR500Mn.

- Enron used special purpose entities and investment partnerships (over 3000) and created series of joint ventures (many involving related parties at Enron) and excluded the results from its consolidated accounts. The method of accounting allowed Enron to materially inflate its profits and to hide debts from shareholders. The JVs used many schemes to enrich senior executives and create bogus profits to drive up Enron share price. At this time, senior executives unloaded USD1Bn in Enron stocks and its young CEO suddenly resigned. The CFO managed to collect additional USD30Mn in fees from these ventures before his forced resignation in October 2001.

- Parmalat, Italy's iconic food and dairy company was declared officially insolvent and termed as Europe's Enron in December 2003. The main reason behind this corporate failure was the loss of focus on core business and various inter-company deals. Attention of the management switched to a tourism agency (Pharmatour) and Pharma Soccer Club where the group lost billions. While accumulating losses, and with debts to the banks, Pharmalat started to build a network of off-shore companies, which were used to conceal losses, through a mirror game which made them appear as assets or liquidity, and company started issuing bonds to collect money. Security for such bonds was provided by the alleged liquidity represented by the offshore schemes. Finally, in December 2003, rumours spread that Parmalat's claimed liquidity was not there. When one of the banks, questioned the bona-fides of a key document sent by Pharmalat to its auditors on the Bank's letterhead stationery, confirming a deposit of Euro 4Bn, it was discovered that its claimed liquidity of Euro 4Bn did not exist and that Euro 8Bn in bonds of investors money had evaporated as well. Parmalat is the largest bankruptcy in European history representing 1.5% of Italian GNP, proportionately larger than the combined ratio of Enron and Worldcom bankruptcies to the US GNP. These are only few recent cases but the list is never ending. It is not a bad idea to go through the non-performing loan portfolio of each bank, where we can find enough of such cases with accounting gimmicks.

10. Conclusion

Despite the coordinated efforts of auditors, regulators and analysts to prevent, detect and eliminate creative accounting and financial gimmicks, the problem continues to exist and would not disappear soon. Therefore bankers and investors should continue the search for such signs and get themselves updated with such cases.

There can be numerous post-mortems after a loan goes bad; but what is vital is to identify problems early. Proper financial risk analysis on adjusted set of financials is the best way to tackle it.

In going forward, benefiting from the lessons learned in corporate failure and spotting early signs of problems, before most lenders do, would be the key to a quality portfolio in the competitive world. It has been tested time and again that early identification of problems in a borrowing relationship provides the lenders a better opportunity to rectify and workout such accounts rather than taking reactive measures.

It is expected that some of the points highlighted in this paper should help bankers and investors to be much better armed for the challenge. If they work hard, be alert and persistent, they can succeed!

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