IJER © Serials Publications
11(3), July-Dec. 2014: 525-533
ISSN: 0972-9380

Game Accountants Play – The Sinful World

Abhishek Ranga*

Abstract: *The case highlights the influence of accounting choice on a firm's reported financial position and financial performance. A firm may influence its reported financial performance and position with its accounting choice. The case discusses common ways adopted by firms to inflate earnings; later it deals with two hypothetical firms A and B, identical in all respect except for the accounting choice. Firm-A which is aggressive in its accounting choice is able to boost its reported financial position and performance and reports better figures compared to Firm-B which supports conservative accounting.*

I. INTRODUCTION

If you are of the opinion that sales isthe responsibility of only the sales manager – you are living in wonderland. Sometimes accountants are much more responsible for generating sales revenue compared to the sales manager and credit for this goes to the complex and creative world of accounting. A firm's accounting choice affects its reported financial position and financial performance and it is possible to influence these reported figures with the accounting choice made by the firm.

General Motors (GM) in 2010, just before its IPO, changed its revenue recognition policy to boost revenue. As per its earlier policy, sales would be recognized only when the final customer purchased the vehicle, but in 2010 instead they started recognizing the moment it was sold to dealers and this resulted in a higher sales recognition for GM. Several investors who purchased GM's "new" stock in the 2010 IPO sued the company for engaging in channel stuffing tomake sales numbers look better and a class-action suit was filed against the company on June 29, 2012.GM common shares were sold by the U.S. Treasury Department and other investors in the IPO at USD33 each, but by July 2012, they had fallen 43 percent to as low as USD18.72.

Though companies have to prepare their accounts as per the defined standards, the pressure to report good results makes them fudge figures. In the income statement firms may deliberately overstate revenues, thereby boosting profit. A few common techniques for boosting revenue are listed below:

* Associate Professor, Goa Institute of Management, *E-mail: abhishek@gim.ac.in*

i. Boosting income with one-time gains: Profits can be temporarily boosted by selling an undervalued asset or by retiring a part of debt. The company may also resort to boosting income from investment gains to hide deteriorating operating results. However, these are not from the firm's core operation.

ii. Overstating earnings: this is done by creating fictitious credit sales or by reducing allowance for bad and uncertain debts. Sometimes the companies may even relax credit requirements to boost sales.

iii. Creating false sales: It could gross up its sales revenue to ignore the cost of selling or treat refunds from suppliers as revenue. It may record 100% sales as revenue, despite incurring a commission. Companies may also include interest income as operating income or consider income from selling current asset as operating income.

iv. Recording sales prematurely: It may consider goods that have been ordered but not shipped as part of its sales revenue. It may also record revenues despite uncertainty in executing the contract or when future services are due.

Another approach towards inflating reported profits is to understate expenses; a few common ways of doing so are discussed below:

i. Deferring or capitalizing expenditure: It includes payments that have been made, but won't be reported as expense until a future accounting period. Instead, it is reported in the balance sheet as an asset till it expires. Many firms even capitalize normal operating expenses as asset and amortize these over a period of time. This reduces the current year expenses, giving the illusion of improved earnings.

ii. Adjusting depreciation: A company can inflate its net income by charging less depreciation on assets. To do so, it can extend the life of an asset or change the depreciation method that it uses.

iii. Overstating current year's expenses for a better future: "Big bath accounting" is the common name in accounting literature for this. If a company incurred a heavy loss in a particular year, they may tend to overstate the expenses, the motive is to understate the expenses in future years which in turn will help in reporting better financial performance in future periods.

II. CREATIVE ACCOUNTING IN PRACTICE

i. Dell received a subsidy of USD 4.2 billion from Intel during 2003 to 2007, it is a different story that Intel offered this to Dell in response to the stiff competition it was facing from rival AMD. Dell put these on its accounting books as a reduction in operating expenses, because they offset its own marketing expenses. The level of financial support was enormous and made a significant difference to Dell's reported financial performance. The payments grew from 10 percent of Dell's operating income in 2003 to 38 percent in 2006. They reached their peak in the first quarter of 2007, when they hit 76 percent of operating income, some USD 721 million.

ii. *"The fourth-quarter loss was due to the business, not accounting. Our marketing and management costs rose because we carried out more marketing campaigns. That's it,"* a Samsung director at the investor relations team said. Samsung was accused of 'big bath accounting' for the fourth quarter of 2008 when it posted a record operating loss of 937 billion won. Back then, the market consensus on the loss was around 400 billion won. It was the first quarterly operating loss of Samsung since 2000, and was caused by rising marketing and management costs of 4.4 trillion won, up 1.15 trillion won from the previous quarter.

    Samsung Electronics' average fourth quarter expenditures on marketing and management from the previous quarter went up by 24.77 percent, from 2000 through 2007. For example, the difference was 503 billion won (22.15 percent) in 2005, 477 billion won (20.12 percent) in 2006 and 463 billion won (17.7 percent) in 2007.

iii. Coca-Cola agreed to pay USD137.5 million (69.4 million pounds) to settle a shareholder lawsuit that claimed the soft drink maker artificially inflated sales to boost its stock price, according to court documents. The lawsuit, filed in October 2000, claimed that in 1999 Coca-Cola had forced some bottlers to purchase hundreds of millions of dollars of unnecessary beverage concentrate in an effort to make its sales seem higher. Bottlers use the beverage concentrate to make soft drinks. The investors claimed that Coca-Cola had failed to disclose material facts about its business and these omissions and misrepresentations harmed investors. Without admitting any wrongdoing, Coca-Cola agreed to the settlement on June 26, 2008 according to court documents obtained by Reuters. The settlement was filed with the court on July 3, 2008. Coca-Cola had previously denied any wrongdoing or liability, but agreed to settle the case to avoid lengthy and uncertain litigation, the settlement said. The settlement applies to anyone who acquired Coca-Cola common stock from Oct 21, 1999 through March 6, 2000, according to the settlement agreement, which was filed with the U.S. District Court for the Northern District of Georgia.

    In 2005, Coca-Cola settled a similar issue over the sale of excess beverage concentrate to bottlers in Japan between 1997 and 1999. "Coca-Cola misled investors by failing to disclose end-of-period practices that impacted the company's likely future operating results," the U.S. Securities and Exchange Commission said at the time. Coca-Cola admitted no wrongdoing and paid no fines in that settlement pact, but agreed to cease and desist from future securities violations and maintain tight internal controls on sales to bottlers and customers. The U.S. Department of Justice had closed an investigation without filing charges against the company.

iv. In June 2002, Xerox revealed that over the past five years it had improperly classified over USD 6 billion in revenue, leading to an overstatement of earnings by nearly USD 2 billion. This announcement of Xerox was not entirely new, since the Securities and Exchange Commission (SEC) had begun an investigation that ended in April 2008. The SEC had charged Xerox with accounting manipulations. It was estimated at the time, however, that the amount involved was about half of that which is now stated, or about USD 3 billion. A settlement was eventually reached that included a USD 10 million fine, as well as an agreement to conduct a further audit; it was this audit that produced the USD 6 billion figure.

    There were two basic manipulations that formed the basis for the SEC investigation. The first was the so-called "cookie jar" method. This involved improperly storing revenue off the balance sheet and then releasing the stored funds at strategic times in order to boost lagging earnings for a particular quarter. The second method—and what accounted for the larger part of the fraudulent earnings—was the acceleration of revenue from short-term equipment rentals, which were improperly classified as long term leases. The difference was significant because according to the Generally Accepted Accounting Principles (GAAP)—the standards by which a company's books are supposed to be measured—the entire value of a long-term lease can be included as revenue in the first year of the agreement. The value of a rental, on the other hand, is spread out over the duration of the contract.

v. Recognition of revenue from sales of licenced software is a subject of interest for both academics and practitioners. It involves application of matching concept, principle of conservatism and needs accounting estimates. Typically over the licence period software providers give free of cost software updates to customers and the cost of software updates needs to be matched with corresponding income. As a practice, software providers recognize a major portion (say 80%) as first year revenue and remaining part is uniformly recognized over the remaining licence period. Microsoft and Computer Associates both were accused for the revenue recognition in the year 1995. Microsoft was aggressively conservative in recognizing revenue for Windows 95, it only recognized 60% in the first year; charges were that Microsoft, in an attempt to smoothen its earnings,was hiding revenue with the use of atechnique popularly known as 'cookie jar' technique. On the other hand CEO of Computer Associates Mr. Sanjay Kumar was aggressive in recognition of revenue and started recognizing 100% revenue in the first year itself.

vi. ONGC, Tata Motors and L&T were accused of understating their borrowing expense. Accounting standard-16 on borrowing cost permits firms to capitalize interest expense on loans used to finance capital asset. These firms capitalized interest expense, but instead of choosing capitalizing period as term of loan, they preferred capitalizing it over the economic life of the principal asset.

vii. Delta airlines in a span of thirty years ,revised the economic life of its aircrafts four times. Each time Delta increased life of its aircrafts by five years, thus reducing the depreciation amount and inflating reported profits.

III. ACCOUNTING POLICY AT FIRM-A AND FIRM-B

We can observe that choice of accounting policy, accounting method and accounting estimates affects a firm's reported financial position and financial performance. Wherever accounting standards (AS) offer options to firms – it is an open invitation for manipulation. For instance AS-6 on depreciation does not suggest a particular way of charging depreciation. Two quite popular techniques often used by firms are written down value (WDV) method and straight line method (SLM). Mostly, WDV charges higher depreciation in initial years as compared to SLM, AS-6 permits firm's to decide on their own the depreciation policy, moreover it also permits firms to change the method of depreciation any time during the economic life of the asset. In such a situation possibility exists that in order to manage the reporting of financial performance, firms may play with their accounting policy. In order to show higher profit, firms following WDV may prefer to use SLM or vice-versa.

This case deals with two software firms A and B, both identical in all respect except for accounting choice. Firm-A is aggressive in recognizing income and understating its expenses, whereas Firm-B supports conservative accounting. Case aims at highlighting the influence of firms accounting choice on its reported financial position and performance. For both the firms, balance sheet, statement of profit and loss and cash flow statement is prepared.

A. For the preparation of financial statements following assumptions are taken:
   i. Actual sales and cash received against sales for both the firms are same for the reported five year period.
   ii. Operating expenses comprising of employee training expense, repairs and maintenance expense and advertisement expense is same for both the firms for the reported five year period, and both the firms makes cash payment in the respective year itself.
   iii. Employee benefit expense for the reported five year period is same for both the firms, it is paid in cash.
   iv. Capital contribution by the owners (shareholders) is only in first year in the form of cash, which is same for both the firms.
   v. Fixed assets were purchased by both the firms in first year only. Fixed assets are exactly identical in terms of nature of use and cost. Useful economic life of assets is 30 years.
   vi. Applicable tax rate (30%) is same for both the firms.
   vii. Numbers of equity shares are same for both the firms.

viii. Software licence period is five years.

B. Accounting Choice:

i. Revenue recognition policy:

a. Firm-A recognizes 100% of its software sales revenue in the year in which sales is made.

b. Firm-B recognizes 80% of its software sales revenue in the year in which sales is made and remaining 20% uniformly over remaining four year period.

ii. Depreciation Policy:

a. Firm-A charges depreciation using straight line method for 30 years.

b. Firm-B charges depreciation using written down value method at 15%.

iii. Accounting treatment for operating expenses:

a. Firm-A capitalizes its training, repairs & maintenance and advertising expense. AS-10 on fixed assets allows to capitalize cost incurred on bringing improvement to the fixed asset, repair cost needs to be treated as revenue expense as and when incurred. But AS-10 is silent in differentiating between these two words 'repair' and 'maintenance'. Similarly as-26 on intangible assets permits firm's to decide on accounting treatment for advertisement cost, it can be expensed or capitalized as per firm's decision. Costs are capitalized for a period of five years.

b. Firm-B treats training, repairs & maintenance and advertising expense as a revenue expense.

iv. Accounting estimates for writing off bad debts and creating provision for doubtful debts:

a. Firm-A as a policy does not write off its bad debts, also it has not created any provision for doubtful debts.

b. Firm-B being conservative in its approach has written off bad debt also they have created provisions for doubtful debts.

Based on these financial statements were prepared for the firms, appendix-1 and 2 contain financial statements and notes for Firm-A and B respectively.

Appendix-1

(Figures in Rs. and Crores)

A. Balance sheet for Firm-A

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
I. EQUITY AND LIABILITIES					
Capital	100.00	100.00	100.00	100.00	100.00
Reserves and Surplus	53.52	54.42	55.13	56.68	58.09
Other lib. (Def. Rev.)	0.00	0.00	0.00	0.00	0.00
Total	153.52	207.94	263.07	319.74	377.84
II. ASSETS					
Current Asset					
Cash	52.72	51.03	49.29	54.48	60.00
Debtors	32.10	67.41	106.25	148.98	195.97
Total Current Assets	84.82	118.44	155.54	203.45	255.98
Fixed Asset					
Gross Block	45.00	43.50	42.00	40.50	39.00
Depreciation	1.50	1.50	1.50	1.50	1.50
Net Block	43.50	42.00	40.50	39.00	37.50
Other Assets	25.20	47.50	67.03	77.29	84.36
Total	**153.52**	**207.94**	**263.07**	**319.74**	**377.84**

B. Statement of Profit and Loss for Firm-A

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Sales	100	110	121	133.1	146.41
Other Income	0	0.00	0.00	0.00	0.00
Total Revenue	100	110	121	133.1	146.41
Employee benefit expenses	15.74	17.31	19.05	20.95	23.04
Operation and other expenses	6.30	13.45	21.70	29.68	38.87
Depreciation and amortisation expense	1.5	1.5	1.5	1.5	1.5
Total Expenses	23.54	32.26	42.24	52.13	63.42
Profit Before Tax	76.46	77.74	78.76	80.97	82.99
Tax	22.94	23.32	23.63	24.29	24.90
Profit After Tax	53.52	54.42	55.13	56.68	58.09
Earnings Per Share	5.35	5.44	5.51	5.67	5.81

C. Cash flow statementfor Firm-A

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Opening Balance	0.00	52.72	51.03	49.29	54.48
Cash flow from financing activities					
Capital	(100.00)	0.00	0.00	0.00	0.00
Net Cash flow from financing activity	(100)	0.00	0.00	0.00	0.00
Cash flow from operating activities					
Cash received from customers	67.90	74.69	82.16	90.37	99.41
Employee benefit expenses	(15.74)	(17.31)	(19.05)	(20.95)	(23.04)
Operation and other expenses	(31.50)	(35.75)	(41.23)	(39.95)	(45.94)
Tax	(22.94)	(23.32)	(23.63)	(24.29)	(24.90)
Net Cash flow from operating activity	(2.28)	(1.69)	(1.75)	5.18	5.53
Cash flow from investing activities					
Purchase of Fixed Asset	(45.00)	0.00	0.00	0.00	0.00
Net Cash flow from investing activity	(45.00)	0.00	0.00	0.00	0.00
Closing Balance	**52.72**	**51.03**	**49.29**	**54.48**	**60.00**

Figures in parentheses indicates cash outflow

D. Schedule for operating expenses for Firm-A

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Repairs and Maintenance	1.80	4.00	6.80	8.80	11.40
Bad Debt written off	0.00	0.00	0.00	0.00	0.00
Provision for doubtful debt	0.00	0.00	0.00	0.00	0.00
Training expense	1.50	3.15	4.97	6.96	9.16
Advertising expense	3.00	6.30	9.93	13.92	18.32
Total	6.30	13.45	21.70	29.68	38.87

Appendix-2
(Figures in Rs. and Crores)

A. Balance sheet for Firm-B

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
I. EQUITY AND LIABILITIES					
Capital	100.00	100.00	100.00	100.00	100.00
Reserves and Surplus	16.53	36.13	59.56	92.17	129.55
Other lib. (Def. Rev.)	13.58	25.13	34.43	41.26	45.39
Total	130.11	161.26	193.99	233.43	274.94
II. ASSETS					
Current Asset					
Cash	68.58	81.81	93.65	109.16	123.56
Debtors	23.28	46.94	72.70	100.78	131.40
Total Current Assets	91.86	128.75	166.35	209.94	254.96
Fixed Asset					
Gross Block	45.00	38.25	32.51	27.64	23.49
Depreciation	6.75	5.74	4.88	4.15	3.51
Net Block	38.25	32.51	27.64	23.49	19.98
Other Assets	0.00	0.00	0.00	0.00	0.00
Total	130.11	161.26	193.99	233.43	274.94

B. Statement of Profit and Loss for Firm-B

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Sales	80.00	91.40	103.93	117.72	132.88
Other Income	0.00	0.00	0.00	0.00	0.00
Total Revenue	80.00	91.40	103.93	117.72	132.88
Employee benefit expenses	15.74	17.31	19.05	20.95	23.04
Operation and other expenses	33.90	40.34	46.54	46.05	52.92
Depreciation and amortisation expense	6.75	5.74	4.88	4.15	3.52
Total Expenses	56.39	63.39	70.46	71.15	79.49
Profit Before Tax	23.61	28.00	33.47	46.57	53.40
Tax	7.08	8.40	10.04	13.97	16.02
Profit After Tax	16.53	19.60	23.43	32.60	37.38
Earnings Per Share	1.65	1.96	2.34	3.26	3.74

C. Cash flow statement for Firm-B

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Opening Balance	0.00	68.58	81.80	93.65	109.16
Cash flow from financing activities					
Capital	(100.00)	0.00	0.00	0.00	0.00
Net Cash flow from financing activity	(100.00)	0.00	0.00	0.00	0.00
Cash flow from operating activities					
Cash received from customers	67.90	74.69	82.16	90.37	99.41
Employee benefit expenses	(15.74)	(17.31)	(19.05)	(20.95)	(23.04)
Operation and other expenses	(31.50)	(35.75)	(41.23)	(39.95)	(45.94)
Tax	(7.08)	(8.40)	(10.04)	(13.97)	(16.02)
Net Cash flow from operating activity	13.58	13.23	11.84	15.5	14.41
Cash flow from investing activities					
Purchase of Fixed Asset	(45.00)	0.00	0.00	0.00	0.00
Net Cash flow from investing activity	(45.00)	0.00	0.00	0.00	0.00
Closing Balance	68.58	81.80	93.65	109.16	123.56

Figures in parentheses indicates cash outflow

D. Schedule for operating expenses for Firm-B

Particulars	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*
Repairs and Maintenance	9.00	11.00	14.00	10.00	13.00
Bad Debt written off	0.00	1.80	2.09	2.41	2.77
Provision for doubtful debt	2.40	2.79	3.22	3.69	4.21
Training expense	7.50	8.25	9.08	9.98	10.98
Advertising expense	15.00	16.50	18.15	19.97	21.96
Total	33.90	40.34	46.54	46.05	52.92

References

Dawn Matsumoto and Robert Bowen (2000), "Microsoft's Financial Reporting Strategy", [HBSP case, 100027].

Floyd Norris and Claudia H. Deutsch (2002), "Xerox to Restate Results and Pay Big Fine", *http://www.nytimes.com/2002/04/02/business/xerox-to-restate-results-and-pay-big-fine.html*

Jessica Hall (2008), "Coca-Cola agrees to settlement in shareholder lawsuit", *http://uk.reuters.com/article/2008/07/07/uk-cocacola-settlement-idUKN0635652020080707*.

Jonathan Stempel (2014), "GM wins dismissal of lawsuit over its IPO", *http://www.reuters.com/article/2014/09/05/us-gm-lawsuit-ipo-idUSKBN0H01RK20140905*.

Kim Tae-gyu (2009), "Samsung Accused of Big Bath Accounting", *http://www.koreatimes.co.kr/www/news/biz/2009/04/123_43235.html*

Lawton Christopher (2007), "Dell Details Accounting Woes; Methods for Recognizing Revenue From Software, Warranties Led to Errors", *http://search.proquest.com/docview/399071331?accountid=45979*.

Michael J. Jones (2011), "Creative Accounting, Fraud and International Accounting Scandals", Wiley [ISBN 9781119978626]

William J. Bruns Jr. and Jeremy Cott (2004), "Depreciation at Delta Air Lines and Singapore Airlines", [HBSP case, 198001].