ACCOUNTING FRAUDS AND EVALUATIVE DISCRETION AREAS: ANOMALIES IN THE ADOPTION OF THE IAS 36

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Abstract

The importance of the balance sheet as an instrument aimed at reducing the information asymmetry between people who manage a company from the inside and who are interested in its economic and financial dynamics from the outside is a key topic in current economics. However, in the balance sheet, which is by nature an administrative document originated from the accounting, all its weakness is also hid, since it is exactly in accounting processing that could be lurked risks of tampering. In fact, the balance sheet is mostly composed of accounting representations of subjective values. It is therefore understandable not only the risk of possible violations of evaluative discretion from who draws up the balance sheet, but also another one, even more “silent”, which involves the final accounting coverage of some given evaluating anomalies, that cannot be tracked later. After a brief theoretical paragraph about the informational value of the financial statement, starting from the clearly essential role of the use of discretion in the balance sheet drafting process, this study focuses on the misuse of this discretion and on the following distorting effects, in terms of alteration of the information process, which is the basis of the relationship between the company and the external environment. The description of a case study about the misuse of IAS 36 in the evaluation of a shareholding gives some significant concrete evidence about the previously formulated theoretical considerations.

Keywords: Balance Sheet, Accounting, IAS 36, Impairment, Devaluation, Evaluative Discretion, Accounting Fraud

1. Introduction

Despite the major reforms in the field of corporate governance that followed the financial scandals in recent decades, corporate fraud still represents a main issue. This is a sharply growing phenomenon in Italy, with the resulting distorting outcomes in terms of inefficiencies in the capital market.

This information results from a study carried out on in 2014 by PricewaterhouseCoopers, which consisted of five thousand interviews of companies from all over the world, Italy included. Figure 1 summarizes the outcomes of the study and shows a significant increase in financial economic frauds in Italy, which grew from 17% in 2011 to 23% in 2014. Although Italy ranks below the global average of 37%, it is worth to point out that this figure is affected by the sharp weakness of the internal control system typical of the Italian companies compared to the other international competitors, which hide both already implemented and ongoing frauds.
Figure 1. Development of corporate frauds in Italy, Europe and in the world
Source: PwC (2014)

The size of this phenomenon is quite serious, especially considering that in Italy the prevailing type of fraud is the accounting fraud, after the misappropriation of business assets. Accounting frauds, especially those originated from accounting estimates, are by their nature exposed to manipulation for two reasons: because there are some unavoidable uncertainties in the underlying assumptions, and because of the information asymmetry between who calculated those estimates and the stakeholders. This is the most dangerous kind of fraud because it is hidden in the report development process, and appears to the balance sheet user as a final flawless representation that covers any former anomaly.

It is no coincidence that these frauds are often identified when it is too late, during the judicial phase and often with an external support (for example of the investigating authorities). In this case, management can no longer do anything to hide them, and it is too late for fixing them anyway.

Moreover, these frauds can damage the company from both the reputational and the economic point of view. They can make an already ongoing crisis worse, leading companies to instability and often producing trickle down on subsidiaries or related companies.

2. The role of the balance sheet

Despite the non-stop proliferation of economic and financial communication channels in contemporary advanced economic systems, for several stakeholder categories the balance sheet keeps on being "the main – if not the only one – source of information about the business situation, in which they are involved to varying degrees (Broglia Guiggi, 2004). Moreover, disclosure of the annual report permits users to comprehend the application of the accounting standards used by entities in order to analyze significant data as stated by Healy and Palepu (2001) and Graham et al. (2005).

The development of the role of the balance sheet over the time can be described as a slow and gradual process in which the essential accounting document changed shapes and contents following the transformation of the object whose dynamics were aimed at representing. According to Ceccherelli (1961), there is no doubt about the origin of the word “balance sheet”, whose elementary, unequivocal and plain accounting originated meaning is that of balance of account. Basically, this word should come from the specific accounting writing typical of the closing of accounts, in which “give” and “take” are perfectly balanced.
Concerning the change of meaning and purpose of the balance sheet, it is known that, initially, it was aimed at updating the business partners about the management’s operations, and at the same time at estimating the periodical economic achievement. Therefore, the prevailing function of the balance sheet was the internal information.

Over the years, with the increase of balance sheet-related rules of law for the legislator’s awareness over the importance of the informational function of the corporate annual statements (Balducci, 2007), the financial statement acquired an even wider informational function, public and outward turning.

Figure 2 schematizes the previously illustrated development process of the balance sheet, which offers also a great summary of the mindset of some Italian authors (Branciari, 2004; Junta and Pisani, 2008) who dealt with the creation and development of the informational trend of the balance sheet.

<table>
<thead>
<tr>
<th>Period</th>
<th>Function</th>
<th>Informational value</th>
</tr>
</thead>
<tbody>
<tr>
<td>at the origin of the accounting discipline</td>
<td>memory and reporting tool</td>
<td>balance sheet as a mere epilogue of accounting records</td>
</tr>
<tr>
<td>in the nineteenth century, with the growth of interests gravitating around the enterprise</td>
<td>instrument for the protection of particular categories of stakeholders</td>
<td>operating balance sheet with a minimum information base</td>
</tr>
<tr>
<td>in the modern economy of complexity and globalization</td>
<td>public economic-financial communication tool</td>
<td>balance sheet as a universal information tool</td>
</tr>
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</table>

Essentially, the more the company has become receptive towards the economic and social context, the more the balance sheet has turned out to be outward turning. The logical connection between the wider function of the balance sheet information and the improvement of the number of stakeholders who are interested in reading this document is fully consistent. Of course, in case of frauds, this will lead to an increase of the possible negative effects.

3. Accounting frauds

In economic and business literature, academics preferred to adopt a “systemic” analysis of the companies. Especially concerning the balance sheet, from the business values systemic conception point of view, the process of corporate economic and financial communication in the field of company-environment relations system, allows the spread of an advantageous exchange of information regarding economic and financial aspects of the management between company and stakeholders, who care about the business performance according to their needs and demands (Di Stefano, 1990).

However, due to the external value of the balance sheet information, these are usually very aggregate, therefore unsuitable for individual business decisions that require instead a more detailed approach and more precise information. Nevertheless, the analytical accounting system, which provides a solution to this problem, gives only internal benefits. It can be deduced that usually the reader of the balance sheet lies in a situation of informational
disadvantage and needs to put in a greater interpretative effort. If there is a lack of transparency and accuracy in the mutual-exchange relation between company and environment, problems will keep on raising. Accounting frauds imply a real gap between the economic-financial real situation of the company and the information about its performance outlined in the balance sheet (Spaventa, 2002).

These mechanisms, therefore, are aimed at separating the economic-financial reality of the company from its representation, thus obstructing the clear opinion of the reader of the balance sheet.

The process of drafting of the balance sheet is in fact illustrated in the doctrine of conversion of the corporate performance into numerical figures (Giannessi, 1960) and the intent of the readers of this essential information comprehends not only the simple reading of the balance sheet, but also a deeper reading of the managerial operations through that balance sheet. Giannessi (1960) defines this concept as the process of reconversion of the balance sheet figures into economic performances. The fraud strongly breaks into this logic, inexorably damaging the circularity of the process.

According to this circular perspective, fraud is meant to be an interruption that breaks the communication process changing its progression, and which lays between the economic-financial position of the company and its account form (Figure 3). In practical terms, even when disclosures are mandatory, firms still have some flexibility in the way they report the information (Chen and Jaggi, 2000; Yeoh, 2005; Chavent et al. 2006; Tsalavoutas, 2011).

An over-reinforcement of the logics and principles that inspire the balance sheet would threaten the significance of the final document. Likewise, a highly discretionary use of these logics and principles would give the management enough space for careless accounting activities, which can be justified anyway. This is a sort of accounting paradox, which involves the process of balance sheet drafting, based on the more or less conscious use of the so-called balance sheet policies. These policies refer to the accounting activities carried out by the management during the drafting of the financial statements, according to the business strategy and the related accounting standards (Pini, 1991).

The usefulness of balance sheet policies is related to the non-automaticity of the process of drafting. The latter does not originate from an “automatic scriptural epilogue” (Migliaccio, 2012); it rather originates from wider business strategies. It is necessary to point out that, usually, these policies are completely legal. They become inappropriate as they are exploited for other purposes. Concerning this last point, there are some authors in the economic literature who described the balance sheet as a behavioral instrument: a means aimed at arousing some desired behaviors and reactions into the subjects (Potito, 1988). Otherwise, external influences give rise to insane balance sheet policies. Tiscini and Di Donato (2005) divided frauds in two main categories, according to their development processes: on the one side we can find the “excessive decision-making power” frauds, while on the other there are the “pressure on the outcomes”. However, on closer inspection, corporate values can be found in balance sheet statements that reflect the behavior of business units often inspired by a set of causes. Managerial operations, affected by the necessary “logical category” of discretion (Verona, 2006) which is sometimes abused (for a lack of supervision in the decision-making and evaluation procedure), do not follow a “pure” economic and accountancy logic, which derives
straightly from accounting figures. Management should also consider the contamination of other undetermined variables (such as market pressures on the outcomes; the desire to achieve goals for personal affirmation; the willingness to make the performance appear even better in some stakeholders’ eyes, who are potential sponsors or investors; the managerial natural tendency for frauds, and so on).

4. A case of fraud in the application of IAS 36 in the evaluation of shareholdings

4.1. The accounting standard IAS 36

The accounting standard IAS 36 describes how to manage the periodic evaluation of shareholdings in subsidiaries and related companies. According to this standard, if the value of the participation drops and does not move upward for a long time, it must be reduced. The existence of this reduction should be checked through the so-called “impairment test”; this must occur whenever there is some clear evidence of a lasting reduction of the value of the participation. The imparity may occur in the case of an individual asset, a set of assets or goodwill (Rodrigues, 2005, p. 278). As argued by Husmann and Schmidt (2008), tests for impairment of assets shall be made annually for certain types of assets, or when indicators of impairment are shown for the remaining assets.

In particular, during this process, it is necessary to consider internal and external impairment indicators. Some examples of internal indicators can be parameters and economic outcomes below expectations, while concerning the external scenario a worsening of the general economic context should be considered.

Management often carries out specific analysis with the fundamental support of external specialists. Whenever the carrying amount of the shareholding is higher than its recoverable value, a reduction in value must be detracted from the value of the shareholding and then reported as a drop in the income statement (Costa and Alves, 2005). The recoverable value is the higher between the exchange value (i.e. the fair value after sale costs) and the use value (i.e. the current value of the expected financial flows).

Especially while calculating the use value, management should base the forecasts of financial flows on reasonable and sustainable assumptions, giving more importance to external information rather than to corporate internal ones. Regarding this, IAS 36 excludes that the expected financial flows refer to future business optimization and restructuring for which there is no formal commitment yet. As a matter of fact, according to IAS 36 during the evaluation of the flows, it is necessary to refer to “present conditions”, and, as it is underlined in IAS 37, if the company decided and already communicated the sale of a business but there is no binding agreement and no identified buyer, it is not to be considered engaged in any sale.

Anyway, in the checks of value, it is always indispensable to consider possible differences between past forecasts and current financial flows, in order to make the impairment evaluations as dependable as possible.

4.2. The case study

The following case is quite unique, since it shows how balance sheet editors managed to adjust economic and financial results, creating illusory expectations in various stakeholders. The management made use of the variable represented by the devaluation of a shareholding, employing the evaluative discretion areas offered by IAS 36. Alfa was an Italian limited company operating in the field of financial equity management, which was listed on the Italian Stock Exchange market. In 2011, the company ran into serious financial instability, and put in use a necessary winding up agreement. In 2007, Alfa decided to invest in Beta, directly holding its 15%. It also held the 100% of a newco created for the management of the participation in Beta: this corporate vehicle held the 50% of Beta. The end of Alfa’s investment in Beta can be traced back to 2011, the year in which beta was placed in extraordinary administration before the compulsory winding up that occurred in 2012.

In 2011, the participation in the financial statement was eliminated: in the scheme of arrangements for the liquidation of Alfa Company, Alfa liquidators declared that the
shareholding in Beta “had an estimated value of zero”. Beta, despite being a distribution network of financial products with hundreds of financial advisors all over the Italian country, is also a bank which manages a great amount of money: about 2.5 billion euros. Its capital and economic decline can be understood through Table 1.

Table 1. Economic and capital data of Beta

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>-24</td>
<td>-47</td>
<td>-20</td>
</tr>
<tr>
<td>Turnover</td>
<td>1</td>
<td>1.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Capital requirement</td>
<td>23.2</td>
<td>27.2</td>
<td>20.5</td>
</tr>
<tr>
<td>Operational risk</td>
<td>18.6</td>
<td>24.8</td>
<td>18.4</td>
</tr>
<tr>
<td>Regulatory capital</td>
<td>13.5</td>
<td>5</td>
<td>-1</td>
</tr>
<tr>
<td>Capital deficit</td>
<td>9.7</td>
<td>32.2</td>
<td>21.5</td>
</tr>
</tbody>
</table>

Source: balance sheets of Beta

The constant loss of Beta is evident, such as the low turnover, a negative supervision asset (which is the first device for safeguarding bank stability) and a considerable capital deficit (despite the non-stop increase of capital signed by several shareholders, included Alfa). On the basis of this introduction, we will focus on the main evaluation processes that affected the impairment of Beta shareholding.

Firstly, in 2008 Alfa performed a general impairment of Beta for 5.6 million euros. The impairment test was based on the ambitious growth forecasts included in the 2009-2011 strategic business plan, which briefly envisaged that the pre-tax profit would have changed from the deeply negative figure registered in 2008 (which at that time was about -18.6 million) to a positive value of 3 million in 2011, with additional positive effects for others 19.3 million, for a total amount of 22.3 million.

It was also envisaged that the Bank would have carried out a new collection, and then moved customer’s money towards the products with higher unitary commissions, thanks to the recruitment of new promoters. This scenario seemed indeed less likely to be outlined, considering the precarious asset and reputational situation of Beta. As a matter of fact, the bank got involved in significant controversies with customers; these were related to the placement of products connected to Lehman Brothers and Morgan Stanley.

It is important to remember that this plan was drawn up a few months after the breakdown of these important banks, whose negative outcomes had just started to show. Besides the lack of consideration towards the difficult general economic context, the evaluation at the base of the impairment of 2008 was originally affected by serious inconsistency. Since it clearly is just a general evaluation arranged by an external consultant, without considering all the prerequisites and standards fixed by IAS 36, it was not meant to be used for the purposes of IAS 36.

Nevertheless, these expectations of uncertain realization led to the limitation of the shareholding of Alfa in Beta, up to 5.6 million. Moreover, the reports of Bank of Italy, well known to the management of both Alfa and Beta, showed substantial lacks in the administration, confirming this concrete uncertainty. The significant operational risk observed in Beta was also stressed out by the unusual composition of the minimum supervision asset registered at the end of 2008, which was only 13.5 million, compared to the 23.2 required by Bank of Italy (Table 1). Furthermore, at the end of the 2008 financial cycle, Alfa and the seller of Beta’s shareholding signed a business agreement aimed at putting an end to all the controversies concerning the original contract about the transfer of Beta. Alfa particularly questioned some seller’s liabilities which were not stated in the balance sheet, connected to the exclusion of several negative elements in the reference sales balance sheets (business devaluations, improper accounting of accruals and deferrals, etc.). This is a credible evidence of the lack of awareness of Alfa about the situation of Beta.

Still concerning a general evaluation arranged by a self-employed external consultant, another impairment about Beta shareholding has been integrated in the balance sheet of 2009. This analysis referred to the use value standard, calculated on the basis of the forecasts
included in the new business plan of the Bank (for the period 2010-2012) and in the plan for the period 2013-2014, as well as in the evaluations for 2015. The plan, which was once again very uncertain, reintroduced the same strategy developed one year earlier, despite the breakdown of 2009. It was meant to develop a new deposits collection, for then moving customer's money towards the products with higher unitary commissions, and finally transferring most of the business costs from the bank to promoters.

This time, however, the evaluator placed an evaluative range of the shareholding between 95 million and 120 million of Euros. The management of Alfa, considering “the strong commitment of Beta management towards the achievement of the plan”, decided to make use of the upper extremity of the range of estimated values producing a devaluation of only 500,000 Euros. Many anomalies showed up also in the devaluation of 2009: firstly, in contrast with the IAS 36, there had been a lack of rationality and essentiality in the analysis of the deviations between past forecasts (such as those used for the previous year's impairing test related to the 2009-11 business plan) and current financial flows, during the discounting of future cash flows. The negative performance of a plurality of cost and cost items already suggested a marked management difficulty in directing the bank towards the desired goals.

Alfa’s management once again seemed to be aware of the seriousness of the variances between expectations and actual values, so that in Beta balance sheet it was reported that the outcomes were “significantly lower than those expected in the 2009-2011 plan”. Furthermore, Alfa had full access to the news about the management of Beta, thanks to the participation of its own managers at the directors’ board of the bank. Still regarding widespread news which were not considered by the management in the evaluation process, even at the end of 2009 the figures about the bank’s financial situation were not positive (Table 1): negative supervision assets for about -5 million, minimum amount of assets set by the Bank of Italy of 27.2 million, in which 24.8 million are due to the single specific requirement on business risk imposed for the financial situation of the bank and the expectations of economic losses.

In the impairment of 2010, the new business strategy implemented by Beta acquired primary importance: at the end of 2010 the directors’ board of Beta ratified a corporate reorganization project that defined the disposal of banking operations and the conversion of the society into a brokerage company.

The impairment of 2010 was based as well on a general evaluation that did not represent a real impairment analysis carried out according to the IAS 36. The consultant evaluation referred to the forecasts included in the new business plan of the Bank (for the period 2011-2016), focused on the already mentioned assumption about transferring the core business to a SIM (Italian Securities Brokerage Company).

In this manner, with a disposal of the banking operations, Beta business would keep on working without the banking license. For their purposes of this study, however, it has to be said that the possible conversion of the bank into a SIM was not assured at all. As specified in the balance sheet of Beta, it was indeed subordinated to the achievement of a business agreement between the bank and the buyer, in addition to the necessary legal permits. At that time, concerning this agreement there was nothing but a general term-sheet, so nothing clear.

This explanation is very important, since as it is stated in the previous paragraph, the forecast flows employed in the estimate of possible impairments should be evaluated according to the “current situation” and should not include flows that are supposed to come from a future restructuring for which a binding agreement does not exist yet.

It is therefore understandable the ineligibility of the consultant's evaluation in the 2010 impairment analysis, since this was mainly based on the evaluation of future flows that were hopefully supposed to emerge from the improvement/ optimization of the performance of Beta through an uncertain corporate reorganization. In fact, the banking disposal has never been implemented, and the resulting corporate reorganization plan was dropped.

The described devaluations for impairment are summarized in Table 2, which shows the final marked devaluation of 2011 as well, with the drop of the shareholding value. Essentially, the corporate management implemented modest corrections of the shareholding value over the time, and then a major devaluation in a single period the devaluation of 42.7 million out of the total amount of 56.7 in 2011.
Table 2. Impairment of shareholding in Beta

<table>
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<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
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<tbody>
<tr>
<td>5.6</td>
<td>0.5</td>
<td>7.7</td>
<td>42.7</td>
<td></td>
</tr>
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</table>

Source: balance sheets of Alfa

5. Conclusion

The described case study is very exhaustive, since it allows the understanding of not only the great amount of evaluative discretion left to the management during the drafting of the balance sheet, but also the results of some questionable evaluation choices in balance sheets. Devaluation in balance sheets is a very delicate issue, especially if the process of drafting follows the international accounting standards.

The present study highlights the highly questionable nature of the assumptions carried out by the shareholder company (Alfa) about the asset dynamics of the shareholding company (Beta). The moderate shareholding devaluations, in fact, are due to Beta’s uncritical adhesion to the relaunch plans that set quite contradictory targets, if we look back at the economic results registered in previous years. This ensured a constant positive level of shareholding for Alfa in Beta, giving a false representation of the real situation to the readers of the balance sheet. Despite the management paid close attention to the projection of flows, these did not follow the sustainability and rationality standards required by IAS 36. Therefore, managerial forecasts have highly overestimated the ability of the bank to gain profit, without verifying the accuracy of the assumptions, which are formulated over the reasons of the gap between past projections and current financial flows, as required by IAS 36.

This is even more important if we consider the causes of these variances, which lay into structural elements concerning costs and earnings of the characteristic management, thus not into extra causes. Obviously, a less generous evaluation of the shareholding would have considerably affected both Alfa and Beta balance sheets. Alfa would have registered even more devaluations and thus budgeting a more negative financial and economic situation, therefore closer to the real one. Besides that, a more realistic awareness of the situation of Beta would have allowed Alfa to optimize financial commitments aimed at supporting the assets of Beta.

Financial support of Beta by Alfa had instead been huge, and it highly contributed to worsen Alfa’s instability. In addition, the described accounting operations allowed Beta to keep on believing into the assumption of the going concern principle, in the balance sheet, rejecting that liquidating perspective which instead was evident.

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