

## Accounting errors and the risk of intentional errors that hide accounting information. The importance and the implementation of the Sarbanes-Oxley Act in Albania

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### Abstract

*Accounting is the language of business! Before any effective decision to be taken, the decision maker should have the financial statements in his hands. In this way his decision is based on the numbers that are produced by accounting. In all those transactions that occur every day in companies worldwide, it happens that errors are made! But how are these errors, involuntary or intentional? The problem starts right here, when we put into question the reliability and accuracy of the information presented in the financial statements. Just mentioning big names like Enron or Lehman Brothers we understand the importance of numbers and "accounting errors" in phrases such as "It's too big to fail". Perhaps the severity of failure or bankruptcy of a company in Albania is not so great but the risk extended throughout the system is threatening for the fragile Albanian economy. Through a case study will address the risk of unintentional and intentional errors occurring in accounting companies, as well as all economic risk as a result of concealment, hiding and manipulation of accounting information. Does Albanians company have knowledge of the Sarbanes-Oxley Act? This paper is seen as a way to give some recommendations to resolve the situation in our country, a situation that can be even in other countries of the world. In the conclusions we will see that these phenomena is the result of lack of control, the preparation of more than one financial statements for the same company, which also contradicts with the IAS for the preparation of the financial statements. This and other related issues will be dealt with extensively in the paper.*

**Key words:** Accounting errors, Accounting risk, Sarbanes-Oxley Act, IAS.

### Introduction

In our life we make many mistakes. As soon as these are detected, he/she corrects them. In the similar manner, an accountant can also make mistakes or commit errors while recording and posting transactions. These are called 'Accounting Errors'. So accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process. These errors may be in the form of omitting the transactions to record, recording in wrong books, or wrong account or wrong totaling and so on. But how are these errors, involuntary or intentional?

The problem starts right here, when we put into question the reliability and accuracy of the information presented in the financial statements. This paper focuses on the nature and incidence of creative accounting practices in the context of ethical consideration. It starts off with the definition of creative accounting, follows by potential and incentives for a company's directors to engage in creative accounting.

The principles of accounting all work to create accounts that are an accurate reflection of the financial position of the company. Profits are neither exaggerated nor underestimated; the balance sheet clearly distinguishes between the different kinds of assets. In contrast to this, there are techniques in accounting that can be used to present the financial position of the company in a favorable light. An error in an accounting item that was not caused intentionally. An accounting error can include discrepancies in dollar figures, or might be an error in using accounting policy incorrectly (i.e., a compliance error). Accounting error should not be confused with fraud, which is an intentional error in an accounting item, usually to hide or alter data for personal gain.

There are various studies that examined the issue of management motivation towards creative accounting behavior. As mentioned by Niskanen and Keloharju (2000), tax is a significant motivator. Imposition of tax levies are based on the

income. The anticipated income has a positive relationship with the psychological expectation. The higher the psychological expectation they aim for, the higher the anticipated income.

The motivation for creative accounting is the gap between the actual performance and the firm expectation when there is a significant capital market transaction anticipated. The variance will lead to manipulation of profit to tie in to forecasts. According to high conservative accounting policy, this means that future earnings are easy to predict as it follows the trend each year. Next motivation is the manipulations earning motives and the executive compensation which is linked to income. Manager's motives are to reduce the perception of variability underlying economic earnings of the firm. For instance, they observe the difference in motivation between managers in owner-controlled and management-controlled firms.

### **Types Of Accounting Errors Based On Their Nature**

The accounting errors based on their nature can be of the following types: 1. Clerical Errors; 2. Errors Of Principle

#### **1. Clerical Errors**

The errors which are committed by accounting clerks are called clerical errors. These errors are committed in the process of recording financial transactions. These take place due to the carelessness of the clerk responsible for recording financial transactions. Clerical errors are also called technical errors. The principal types of clerical errors are as follows:

##### **a) Errors Of Omission**

The errors committed by not recording a transaction either in the book of original entry or in the ledger book are errors of omission. Such an omission may be either complete or partial.

##### **b) Errors Of Commission**

The errors which are committed while recording or posting a transaction are called errors of commission. Errors of commission may take place either in the journal or in the subsidiary books, or in the ledger. Such errors include posting wrong amounts, posting on wrong side of accounts, wrong totaling or carrying forward, and wrong balancing.

##### **c) Compensating Errors**

Compensating errors refer to two or more errors which mutually compensate the effects of one another. If one error balances the effect of another error, then the two errors are called compensating errors.

##### **d) Errors Of Duplication**

Errors of duplication are those errors which arise because of double recording. Double posting of a transaction from journal or subsidiary books to ledger also create such errors. For example, goods sold to John, but this transaction is wrongly entered twice or more in the sales book or wrongly posted twice or more in John's account then it is called the errors of duplication.

#### **2. Errors Of Principle**

Errors of principle are those errors which occur by violating the principles of accounting. Errors of principle may occur due to wrong allocation between capital and revenue expenditure, or wrong valuation of assets. For example, debiting the wage account instead of machinery account for the wage paid to the mechanics used for the installation of machine and debiting the customer's account instead of cash account for the cash sales made. Errors of principle may also occur due to wrong valuation of assets by higher level staff.

### **On the basis of impact on ledger accounts**

Errors may affect one side i.e. either debit or credit side of an account or its two sides i.e. both debit and credit thus errors may be divided as:

#### **(a) One sided errors and (b) Two sided errors**

##### **(a) One sided errors**

Accounting errors that affect only one side of an account which may be either its debit side or credit side, is called one sided error. The reason of such error is that while posting a recorded transaction one account is correctly posted while the corresponding account is not correctly posted. This type of mistake does affect the trial balance.

### **(b) Two sided errors**

The error that affects two separate accounts, debit side of the one and credit side of the other is called two sided error. Example of such error is purchase of machinery for Rs.1000 has been entered in the Purchases Book. In this case, Purchases A/c is wrongly debited while Machinery A/c has been omitted to be debited. So two accounts i.e. Purchases A/c and the Machinery A/c are affected.

### **DEFINITION OF CREATIVE ACCOUNTING**

Creative accounting is referred to also as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting. The USA prefers to use the term of 'Earning Management' while for Europe countries, the preferred term is 'Creative Accounting'. We are using the term of 'Creative Accounting' in this paper because some accounting manipulations involve primarily balance sheet rather than earnings management.

There are several definitions of creative accounting as shown below:

Barnea et al (1976) stated that creative accounting is the deliberate dampening of fluctuation about some level of earnings considered to be normal for the firm.

Schipper (1989) said that 'creative accounting' is similar to 'disclosure management', 'in the sense of a purposeful intervention in the financial reporting process.'

"Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers' desire, by taking advantage of existing rules and/or ignoring some or all of them". Naser (1993:2)

Earnings management is another form of creative accounting and it is generally described as a purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives.

"Earnings management is recognized as attempts by management to influence or manipulate reported earnings by using specific accounting methods (or changing methods), recognizing one-time non-recurring items, deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings". By Bruns and Merchant (1990) in Akers, et al (2007:1)

### **TECHNIQUES OF CREATIVE ACCOUNTING**

The potential creative accounting has found in six principal areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgments in respect of assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers.

The first technique is the regulatory flexibility. The accounting regulation allows people to choose policy. For instance, the company can make choices in respect of asset valuation. International Accounting Standards can make choices by carrying non-current assets at either revalued amount or depreciated historical cost.

The second technique is about limitation of accounting regulation in some area. There is some area that is not fully regulated. There are a few mandatory requirements in respect of accounting for stock options. Besides, the creative accounting does not follow accounting regulation when recognizing and measuring pension liabilities and certain aspects of accounting for financial instruments.

The third technique is about the discretionary areas. For instance, examine the discretionary and non-discretionary elements of the bad debts provision.

Besides, having a good timing for some transactions can impress the account. For instance, a business with an investment at historic cost can be easily sold for higher sales price than its current value. The managers can choose which year he wants to sell the investment in order to maximize profit.

Genuine transactions can also be timed so as to give the desired impression in the accounts. As an example, suppose a business has an investment at historic cost which can easily be sold for a higher sales price, being the current value. The managers of the business are free to choose in which year they sell the investment and so increase the profit in the accounts.

Next, the artificial transactions can be entered to manipulate balance sheet amounts and profit between accounting periods. For instance, an arrangement to sell an asset to a bank follows by the lease of the asset back for the rest of its useful life. The sale price under the sale and leaseback can be artificial and the difference can be compensated by the increased and reduced rental.

The last technique is reclassification and presentation of financial numbers. The firm may want to have a good reported liquidity and leverage rate by manipulating the balance sheet figures and reclassify the liabilities.

#### BALANCE SHEET 2013 STATEMENT FOR BANK

CASH	3,757,881	CURRENT LIABILITIES	180,742
INCOME TAX PREPAYMENT	205,985	CAPITAL	100,000
INVENTORY	0	LEGAL RESERVES	10,000
BUILDING	917,933	OTHER RESERVES	4,543,399
		NET INCOME	47,658
TOTAL	4,881,799	TOTAL	4,881,799

#### BALANCE SHEET 2013 REAL STATEMENT

CASH	7,897,722	CURRENT LIABILITIES	155,523,554
INCOME TAX PREPAYMENT	7,842,121	CAPITAL	100,000
FINANCIAL INSTRUMENTS	89,592,075	LEGAL RESERVES	10,000
INVENTORY	61,185,042	OTHER RESERVES	9,973,209
BUILDING	41,538	NET INCOME	951,735
TOTAL	166,558,498	TOTAL	166,558,498

The voices that we notice with a big difference from the real statements are: Inventory from 61,185,042 it is declared 0 for the bank; Receivables from 89,592,075 in 0 for the bank; And the biggest difference is in the liabilities from 155,523,554; Account payables 47,385,012, loans and overdrafts 68,537,754, accrued liabilities 39,480,192 and wages and taxes liabilities 120,596. The problem is that we don't know which of this statement is the real one, that one that is declared at the tax authorities or the other for the bank OR NON of them!

If the balance sheet that is declared at the tax authorities is near of the real one, while the bank is in trouble because has false information and is giving loan at high risk. So neither the bank has the real situation of the entity, nor the tax authorities. Hiding all this information just to get other loans is a big problem because the entity is going down more and more and the bankruptcy is at the door. Imagine now if this is a procedure for a lot of firms in our country and not only. The risk that the economy is facing is too high because the Albanian economy is too fragile to support such a crisis situation.

#### The ethical perspective

Revsine(1991) argues that both managers and shareholders can benefit from creative accounting. Managers are able to maximize their compensation by influencing the company's reported earnings. Shareholders also enjoy advantages of "smooth income" in the form of good shares price as the results of reducing the obvious volatility of earning and other management action such as attempting to avoid default on loan agreements.

Merchant and Rockness (1994) give an opinion that accountants are more serious of abuse of accounting rules than of manipulation of transactions. Two potential rationales are discussed by Fischer and Rosenzweig. Firstly, accountants may show less concern on the impact on users of the accounting figures, instead, they may apply the rule-based approach to ethics. Secondly, accountants also may not see their responsibility in the manipulation of transactions which they always

think it is the domain of management and thus not subject to the same ethical code. In this case, accountants may only see abuse of accounting rules as falling within their domain. Besides, these researchers also come across that creative accounting based on self-interest of management may attract more disapproval compared to a motivation of theirs which is to promote the company.

However, accountants or managers may ruin their reputation and subsequently affect their career path if there is failure to take a stand against creative accounting particularly when they come to proposed accounting method which is in fact unacceptable. They are facing the same pressure as any other whistleblower. Therefore, Hamilton (1991) offers some suggestions to these people in order to cope with the above mentioned problem. The very first step for an accountant or especially a manager to do is to verify his or her suspicious about fraudulent things, as some accounting practices which look illegal are legal in fact. Next, look for alternative ways to reach the desired results and then recommend these as an alternative option to the management. If the management is still insisting on their way, a report should be made to the appropriate monitoring body.

Sarbanes–Oxley, Sarbox or SOX, is a USA law that set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It was named after sponsors U.S. Senator Paul Sarbanes and U.S. Representative Michael G. Oxley. As a result of SOX, top management must individually certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the independence of the outside auditors who review the accuracy of corporate financial statements, and increased the oversight role of boards of directors.

The bill was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, WorldCom, etc. These scandals cost investors billions of dollars when the share prices of affected companies collapsed, and shook public confidence in the US securities markets.

The act contains 11 titles, or sections, ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission to implement rulings on requirements to comply with the law. The act also covers issues such as auditor independence, corporate governance, internal control assessment and enhanced financial disclosure. The nonprofit arm of Financial Executives, Financial Executives Research Foundation (FERF), completed extensive research studies to help support the foundations of the act.

Albania is a small country with a small fragile economy. This act does not exist in our country but its existence would be helpful for us. Considering that accountants are all time under the pressure of managers to present double statements at same time, one for tax authorities and the other for themselves or banks to prevent a loan the situation is out of control. It would very helpful if banks would accept only the financial statements presented at tax authorities. But first of all we should learn that fraud will not send us anywhere.

## RECOMMENDATION AND CONCLUSION

How can prevent fraud? The secret is in the accounting principles:

The principle of consistency of method. As this implies, the same methods must be used to calculate such things as stocks and depreciation from year to year. New methods can be employed, but if so, these must be indicated in the accounts. If consistency of method is not applied there is scope for intentional or unintentional fraud.

The principle of verification requires that all statements in the accounts must be capable of confirmation by independent persons. This also means that the totals of the revenues and expenditures must be capable of being matched with the figures in the books, ledgers and journals of the business.

The principle of matching requires that revenue must be matched with expenditure and vice-versa. Accounts divide the activity of the business into accounting periods, which may be days, months, quarters or years. The balance sheet in effect takes a snap shot of the business at the end of each accounting period. The principle of matching requires that the snap shot should not include items that do not belong to that period. Thus a prepayment for an item that will be manufactured in the next accounting period does not belong to this accounting period, and should not be included in this accounting period.

Why do Companies have to annotate the accounts they submit to the Tax authorities detailing the methods they used in compiling them? This is to prevent fraud. The value of the profits recorded by the company, depend on the way in which those profits are calculated. The company can, by changing its methods of, for example, stock evaluation, either inflate or deflate the figures for the profits. Hence, every change to the methods of accounting should be recorded.

How does the principle of verification help to prevent fraud? This means that the tax inspectors should be able to check

every entry in the accounts against a physical record of a financial transaction. If a company makes a purchase it needs to keep the receipt. The receipt is logged in a ledger, and from the ledger the final accounts are prepared. The Inland Revenue are able to check (verify) the transaction against the receipt. The need to meet this requirement prevents fraud as a deterrent, since it is easy to cheat, but also cheating can be discovered and punished.

Reducing the choice of accounting methods by limiting the permitted accounting methods or specifying conditions in which method should be adopted. Consistency in using the accounting methods is emphasized.

Outline rules that lessen the use of judgment. Auditors' role is also important in identifying fraudulent estimates. Implement the concept of 'substance over form' to deal with artificial transactions. Next, reevaluate items in the accounts regularly to identify gains or losses on value changes in the accounts as they occur each year. Besides changes in accounting regulation, ethical standards and governance codes in the corporate world must be enforced thoroughly.

The Government is still not doing enough to make sure that all the statutory bodies are converged in a manner that there are no contradictions within themselves. There should be an active participation of the professionals in this process. At present this is clearly absent.

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