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BASRI ABD. GHANI

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RENCANA

Towards Academic Excellence Through Performance Appraisal	MARY MAGDALINE PEREIRA	1
An Evaluation Of The Materials Used For The Teaching Of English In Mara Institut Of Technology, Sarawak	RAZLAN ABDULLAH MARIAH ABDULLAH	7
The Use Of Linear Discriminant Function In Profitability Analysis Of The SMIS	YAP YIN CHAN SOON HUAT	13
Creative Accounting - An Insight Into The Nature And Extent Of Manipulating Corporate Profits	ALLAN CHANG AIK LENG	25
25 Years Of Asean Economic Cooperation: A Critical Overview	NICHOLAS AMIN	33
Membuat Keputusan Secara Statistik Dalam Keadaan Ketidakpastian Dengan Menggunakan Kebarangkalian Awal	CHONG LENG FOOK BADRON HJ. ABDUL MANAF	46
Jenayah Dan Hukuman Dalam Islam	MOHD ADIB SHUJAA BIN AHMAD	52
Koperasi Dari Perspektif Islam Satu Pendedahan Awal	BASRI ABD. GHANI	60

TOWARDS ACADEMIC EXCELLENCE THROUGH PERFORMANCE APPRAISAL

by
Muz Muzaidah Perera

INTRODUCTION

"Performance" and "productivity" have become words in the lexicon of research scientists in almost all fields of science since the early 1950s. The concept of the performance appraisal has been defined by the use of the term "performance appraisal" which is the process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives.

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OBJECTIVES OF PERFORMANCE APPRAISAL

The main objective of performance appraisal is to provide a regular study and evaluation of the performance of employees. The performance appraisal is a process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives.

Moreover, a society does performance appraisal in a wide range of activities and for different purposes. The performance appraisal is a process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives. The performance appraisal is a process of measuring performance against a set of standards and objectives.

CREATIVE ACCOUNTING - AN INSIGHT INTO THE NATURE AND EXTENT OF MANIPULATING CORPORATE PROFITS

by

Allan Chang Aik Leng

INTRODUCTION

Creative accounting is more widespread than is normally understood. This is confirmed by Ian Griffiths. He asserts, "Every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse".

And he goes on to say that any accountant "worth his salt" will confirm that this is no wild assertion. His usage of such phrases as 'cooking the books', 'fiddling the accounts' and 'corporate con trick' may suggest something illegal. On the contrary, it is legitimate and is commonly referred to as creative accounting.

MEANING OF CREATIVE ACCOUNTING

What creative accounting means is that companies strive to translate their activities of the year into reported results which flatter the management and their share prices. The methods employed in manipulating the figures vary from the very simple to the latest, highly sophisticated schemes which defy detection.

REASONS WHY COMPANIES MANIPULATE PROFITS

Firstly, creative accounting is possible because of the flexibility and vagueness of the accounting rules and company laws, the so-called 'grey areas', which govern the preparation and presentation of financial statements.

Secondly, creative accounting has become more popular with companies because of the pressures imposed on their management to report favourable results. The pressures come from the users of financial statements who are big institutional investors and an increasing number of small individual investors. These users demand that companies produce a steady growth in profits and that they consistently live up to the expectations imposed on them by an army of financial analysts and research teams. These analysts from big stockbroking

houses forecast the profits of a particular company and then use these projections as the basis for persuading clients to buy or sell the shares. The successful company is one which can match the analysts's forecast with the actual reported results. If a company is too conservative at the outset, there will be no incentive for analysts to advocate that its shares be bought. The whole aim is to create an atmosphere of 'buy the shares now and buy even more shares later'. The accomplished creative accountant, using the tools of his trade, will link the absolute reality of trading performance with the relative illusions of reported results. Consider this example: Two companies A and B produce the following pre-tax results for four years.

PRE-TAX PROFITS/ (LOSS)		
	COMPANY A	COMPANY B
Years	(Millions)	(Millions)
1	1	4
2	2	(1)
3	4	15
4	8	(3)
TOTAL	15	15

The aggregate profits of the four years for both companies are the same, but company A would definitely be viewed more favourably than company B as the former has a record which reveals profits doubling each year. The latter which has an erratic trading pattern would be regarded as more risky in financial management terms. In fact, company B's results reflect accurately the trading pattern of its business. Unfortunately, the stock market simply prefers the fantasy of smooth growth to the reality of fluctuating operational performance. It falls back on the creative accountant to ensure that those fluctuations are removed by hoarding profits in the years of plenty for release in the years of famine.

Thirdly, in his task of puffing up the company's share price the creative accountant is supported by a battery of press relations people, corporate communications consultant and investors relations advisers. Their life's work is to boost the company's share price and stock market rating. This may appear to be a worthy objective. A high share price, after all, reduces the chances of a company being taken over while at the same time increases its chances of

making an acquisition. The merger mania which has swept the country recently has forced both predators and defenders to search for new weapons which can be brought to bear on the opposition. Hardly a contested bid goes by without either side resorting to creative accounting to bolster its own position, while at the same time criticising the opponent's methods of preparing and presenting financial information.

CONTRIBUTORY ROLE OF AUDITORS

An auditor who is employed, in theory, to protect and act on behalf of the shareholders, can do little to discourage such manipulations. This is because, in practice, the questions are those of judgement and not of fact. The auditor may persuade the company to follow his way on some aspects but will eventually allow the company to take a more liberal interpretation of the rules. The auditor also faces difficult practical and commercial pressures due to the intense competition to secure clients in a stagnant audit market. The company directors take advantage of this and could suggest that failure to come round to their way of thinking in a particular issue might result in the audit assignment being put out to tender.

SCHEMES USED IN CREATIVE ACCOUNTING

There has been a steady increase in the number of schemes which are not visible even by the best trained accountant. Such a sinister aspect of creative accounting arises from 'off balance-sheet financing'. This involves adapting schemes which actually exclude existing figures altogether from the financial statements. It is impossible to detect them even from a detailed analysis of the small print in the notes to the accounts. The reason for a company to take advantage of these schemes is normally to allow it to obtain funding which it would otherwise have been unable to secure. Debt levels may already be uncomfortably high, making it impossible for a company to secure the additional cash needed to finance its capital investment programme. These schemes threaten to undermine the credibility of the statutory accounts.

The statement of standard accounting practice (SSAP 21) does help to reduce the extent of off balance sheet finance in respect of assets held under leases. However, in other cases, SSAP does not help much because the standard is itself designed to encourage flexibility. The standard is not intended to lay down specific accounting treatments, but rather to narrow down the range of options which should be consistently followed in order to improve the comparability of accounts from one year to another and between one company and another. The system recognizes that different businesses will find different methods of accounting more appropriate for reflecting their performance more fairly.

LIMITATIONS OF CREATIVE ACCOUNTING

Creative accounting cannot support the results of a company which is facing genuine and continuing trading difficulties. All that it can do is to defer and mitigate the bad news until there is a revival in trading fortunes. It cannot make bad news look good in perpetuity without resorting to outright fraud. The wisest companies are those which use creative accounting to keep control not just of their figures but also of the share price itself.

Let us now look at six interesting cases in creative accounting. These are actual cases of companies in the United Kingdom and Malaysia involved in some sort of manipulation to improve their reported results. They serve to illustrate schemes used in creative accounting in practice.

CASE 1: HOW PLESSEY MANIPULATED PROFITS

Plessey, the electronics giant, accounted for sales of its System X digital telephone exchange equipment to British Telecoms as follows: Payment is made for the equipment in five separate stages: an order, on shipment, on installation, on commissioning and on completion of a warranty period which normally lasts twelve months. Plessey is careful not to divulge what proportion of the total price is handed over at each stage. The reason for not disclosing this information is that it is a commercial secret and is therefore confidential. This gives rise to room for manipulating profits at any of the five stages. Income could be recognised in full at any stage. In Plessey's case the company takes the full profit when the title passes to British Telecom, less a provision for the warranty.

Plessey could get away with this kind of creativity using the cloak of commercial secrecy. It was therefore not necessary to disclose how its income was to be recognized. If the auditors are doing a good job, they should ensure that the chosen basis be used consistently one year after another as this could probably limit future manipulations.

CASE II: HOW DEBENHAMS MANIPULATED EPS

This case concerns the treatment of property sales in the accounts of House of Fraser and Debenhams. Both companies are in exactly the same line of business which is essentially running departmental stores. In their accounts for year 1985 the two companies reveal a starkly contrasting view on property disposals.

The House of Fraser accounting policy on property sales read: 'surpluses realised on the sale of properties and fixed assets investments, less the reorganisation and closure costs which precede and relate directly to the sale of properties are reported as extraordinary items as these transactions are not considered to be part of the ordinary activities of the group'.

The Debenhams accounting policy on the disposal of properties said: 'where the group disposes of substantially all its interest in a property, the profit or loss, being the difference between the net proceeds of sale and historical cost, is taken to profit and loss account and included in other items'.

The effect of the two different approaches to dealing with the same item was that in 1985 Debenhams boosted its 'above the line' profits by 3.5 million as a result of its property disposals. House of Fraser disclosed a surplus of just under one million below the line as extraordinary income. Debenhams was able to increase its earnings per share before extraordinary item. The company could get away with this practice because of the vague rules on when an item should be classified as extraordinary rather than exceptional even though SSAP 6 has detailed certain rules. There is room for manipulations as the Accounting Standards Committee gives plenty of leeway and recognizes that 'what is extraordinary in one business will not necessarily be so in another'.

CASE III: HOW BOC GROUP SHOWED BETTER OPERATING RESULTS BY EXCLUDING A SUBSIDIARY

BOC Group excluded its entire Nigerian subsidiary from its 1983/84 accounts because the company was undergoing severe problems. By excluding the heavy losses of its subsidiary from its group's results, the group was able to show better performance. The amount of the holding company's investment in the subsidiary was retained in the consolidated balance sheet.

It is possible to get away without making any provisions to reflect the local problems because the rules for consolidation is rather flexible. According to company legislation, a subsidiary may be excluded from consolidation:

- a) where it would be impractical or of no real value;
- b) where inclusion could involve disproportionate expenses or delay;
- c) where inclusion could be harmful or misleading; and
- d) where the business of the holding company and the subsidiary is so different that they cannot be reasonably treated as a single entity.

SSAP 14 recognizes that dissimilar activities are sufficient grounds for exclusion. It also cites lack of effective control and the situation where control is only intended to be temporary as further reasons for leaving out a subsidiary's results. Finally, it permits exclusion when the subsidiary is operating under severe restrictions.

CASE IV: HOW REDLAND FIDDLED WITH FOREIGN CURRENCY TRANSLATION TO IMPROVE REPORTED PROFITS

Redland added 3 million to its profits by switching from closing rates to average exchange rates in 1985. This eased the company's profit up to 108

million and to the stock market's expectations. Similarly, Rank Hovis Mcdougall increased its profits by 2.7 million with a similar switch for the year ended 31 August 1985, and helped the group's profits up to 71.5 million. Both companies are able to get away with this practice because SSAP 20 provides lots of flexibility to use either method to translate the results of overseas subsidiaries and incorporate them into their consolidated financial statements. The switch was made because the closing rate of exchange was higher than the average rate, and therefore, the average rate would give higher figures of reported profits.

CASE V: HOW SYSTEM DESIGNERS INTERNATIONAL BOUGHT INSTANT PROFITS BY GETTING AWAY FROM ACQUISITION ACCOUNTING

System Designers International (SDI) used a vendor rights scheme to acquire a US software company called Warrington in February 1985. The scheme basically enabled SDI to acquire its subsidiary on the basis of merger accounting instead of acquisition accounting. The latter method would have frozen pre-acquisition profits of the acquired company and created a fictitious asset called goodwill. Such fictitious asset would have to be gradually written off and this would have dampened reported profits of the company.

Initially, there were two main problems for SDI. The purchase price of 23.5 million was well in excess of Warrington's net assets and the consequent goodwill would have been too large to be absorbed by SDI's reserves. Secondly, the US shareholders who wanted cash were not keen to accept shares in an USM (Unlisted Security Market) quoted company as the purchase consideration. On the surface, it seemed then that the deal would be stymied. The need to pay cash for Warrington meant that acquisition accounting would have to be used.

The way round this dilemma was a vendor rights issue. SDI issued shares to its merchant banker, Samuel Montagu, which in turn offered them to SDI's shareholders. Those who didn't want the additional shares then sold their rights, and this stock was placed with institutions. The cash raised by this vendor rights issue was then, in effect, handed over by Samuel Montagu to Warrington's shareholders. Everybody was happy: SDI got Warrington without creating goodwill, the Warrington shareholders got the cash they wanted and SDI shareholders suffered no dilution of their investment.

Further, the rights discount using this scheme was only 9 per cent against the market norm of around 20 per cent and the cash was made available immediately rather than after the usual three-week gap.

SDI could get away with this because the scheme complied completely with the letter of the relevant rules. It only contradicted the spirit of those rules to allow the perpetrators to achieve their desired effect.

CASE VI: HOW MALAYSIAN AIRLINES WINGED AN INCREASE IN PROFITS DESPITE HARD TIMES

Malaysian Airline System Bhd winged a 5.3 per cent rise in group pre-tax profits to RM153.45 million for the six months ended September 30, 1992 from RM145.68 million in the previous comparable period. This was an incredible achievement taking into consideration the very strong competition in the airline industry and the strengthening of the ringgit against the US dollar during the same period. The intense competition in the airline industry caused a drop in overall load factor while the strengthening of the Malaysian ringgit resulted in losses to MAS.

However, on careful examination, the favourable results were achieved largely due to a surplus of RM217.7 million from the sale of aircrafts and apartment/house abroad. For the six-month period under review, MAS sold five B737-200 and two DC10-30 aircrafts and aircraft spares for a total of MR217 million and one house in Jakarta and three apartments in London to add on RM700,000 in profits. In the airline industry, aircrafts are normally bought through leasing. When the lease instalments are fully paid, these aircrafts are bought legally for a nominal sum which may be as low as RM1.00. This means the whole proceeds from the sale of aircrafts become a surplus contributing directly to reported profits.

If MAS had not sold these aircrafts and properties abroad, the reported results would have turned into red with a reported loss of RM64.25 million. The immediate outcome could have been a disastrous fall for its share price. It is interesting to note that MAS had not done anything illegal. In fact, this is highly justified in view of the fact that MAS is a public quoted company. If losses had been reported many jittery small investors would have been highly alarmed and would probably unload their shares in the stock market. This may cause embarrassment to MAS and the government.

All companies, especially those that are publicly quoted are under intense pressure to show better performance than the previous year. Such creativity in MAS had made everyone happy. Its performance was seen in better perspectives because it indicated an increase of profits over the corresponding period of the previous year. Its share price did not tumble and in fact, showed a slight rise.

CONCLUSION

Creative accounting can justifiably be used to iron out short term difficulties which might otherwise attract undue concern, particularly to 'smooth out' profits or losses so as to retain investors' confidence. The key to effective use of the various schemes is moderation. In the long run creative accounting is no substitute for sound trading and business development. Any attempt to make

that substitution over a sustained period of time will ultimately result in a catastrophe. It is, therefore, up to the company's management to use creative accounting with the integrity and respect it deserves. More importantly it is up to the individual shareholders to study financial statements more closely to ensure that minimum standards of reporting are upheld and maintained.

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