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When financial reporting misrepresents the figures

WHEN we hear the words "creative accounting", many of us probably think of something dishonest. But does creative accounting really mean "create-a-thief"? Not necessarily.

Recent developments surrounding Tabung Haji have reinforced this perception. The Royal Commission of Inquiry (RCI) described certain practices as "creative accounting", raising questions about how accounting choices and judgements can affect reported financial results.

To understand this, we first need to appreciate something rarely explained outside accounting classrooms. Financial reporting is not simply about adding up money received and subtracting money spent.

Modern accounting standards often require management to make estimates, exercise judgement and, in some circumstances, choose between permitted accounting policies.

Take depreciation and inventory as examples. A company does not simply write off a machine's cost immediately. Management estimates its useful life and consumption pattern, which directly affects reported profit.

Similarly, for interchangeable items, standards permit choices such as first in, first out or weighted average cost, each producing different inventory and cost figures.

Then there are estimates involving asset values, impairment, provisions and expected credit losses. These cannot always be determined with mathematical precision. They require assumptions and judgement based on the best information available.

This is important because accounting standards are designed to capture economic reality, not simply impose mechanical rules. Management therefore has to make informed estimates and document the basis for its decisions.

That discretion is necessary, but it also carries a responsibility on management to exercise it with integrity. This is not necessarily manipulation; it is part of accounting. The problem begins when legitimate judgement crosses the line into deliberately misleading reporting.

This distinction is important when looking at the Tabung Haji RCI report. The Commission found that Tabung Haji reported a RM3.4bil profit for 2017 when, had the Malaysian Financial Reporting Standards been fully applied, it should have recorded a RM1.4bil net loss.

The RCI also identified issues involving impairment, declines in fair value and the recognition of dividend income, among other matters. The report also referred to the use of the Realisable Asset Value approach in determining whether Tabung Haji could distribute hibah.

The findings highlight how accounting judgements and practices can materially affect the financial picture presented to stakeholders. This is why the term "creative accounting" has attracted public attention.

Not all cases fall into this grey zone, however. Other Malaysian cases demonstrate a much clearer crossing of the line. In the Transmile case, a special audit found that revenue for 2004 to 2006 had been overstated by RM622mil.

In the Serba Dinamik case, the Securities Commission took action over a false statement relating to RM6.014bil in revenue reported to Bursa Malaysia.

These are not simply examples of management choosing between legitimate accounting alternatives. They illustrate what happens when financial reporting no longer faithfully represents economic reality.

Perhaps the easiest way to understand the issue is to see it as a spectrum. At one end is legitimate accounting judgement. Further along comes aggressive accounting, where management pushes interpretations towards their limits. At the other end is deliberate misrepresentation and fraud.

The important question is not simply whether management exercised discretion.

Management must exercise discretion because businesses are complex and accounting standards cannot prescribe every possible situation.

The better questions are: Was the treatment permitted? Was the judgement reasonable and supported by evidence? And did the resulting financial statements faithfully represent the underlying economic reality?

So, the next time "creative accounting" is mentioned, we should not automatically assume that someone has cooked the books. Creativity in accounting is not necessarily the problem. What matters is what management does with that creativity.

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