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How An Accountant Can Destabilize A State?*

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Abstract: Discussion on systematic risk in terms of companies business is mostly related to financial institutions which are considered to be the bloodstream of every economy. They are often considered to be »too big to fail« and the bailout or the bail-in process is considered to be the most appropriate to eliminate the aforementioned risk. This processes became popular not only in financial, but as well in other industries where governments tried to eliminate various risks (not only systematic one) that are not rarely the results of deficiencies in neoliberal market economy concept. This paper presents a comprehensive view on importance that one nonfinancial conglomerate had and still has in (post)transitional economy – economy of the Republic of Croatia and surrounding South East European countries in which it operates. The breakdown of this conglomerate has been stopped or delayed; next year will be crucial for its future. In the meanwhile authors discuss mainly from accounting but also from other important perspectives on how did the conglomerate grow, how did it get into the problems and what disruptions in national and international economies it brought: from potentially rise of unemployment, liquidity and insolvency problems of its suppliers and economy as a whole and problems in supply chain of its customers to positioning of global superpowers that use the conglomerate to take their geostrategic position on traditionally political unstable area in South East Europe. Authors used descriptive scientific method in elaborating the accounting and other views on the problems that conglomerate brought. Comparing various sources of data authors try to deduct conclusions on the importance that big companies could have in a small and open economy and how fraudulent financial reporting could seriously destabilize a state. The scope of this paper with provocative title is to emphasize the importance on corporate governance, risk management and finally responsibilities of accounting and auditing profession.

Keywords: *Accounting Scandals, Fraudulent Financial Reporting, Conglomerates, Systematic Risk, (Post)Transitional Economies*

I. INTRODUCTION

Who is the accountant and is this person so important to destabilize a state? If this person is so competent the question can be focused on the company or conglomerate that he or she is working for and the "kind" of state in which conglomerate is doing business. Definitely, authors are not talking about one person that prepares financial reports, neither about a low income state with poor democracy and nonexistent market institutions. They are trying to elaborate the case of conglomerate accounting scandal whose headquarter and most of its activities are located in EU member state classified into the upper middle income category [1]. They are writing about the conglomerate that financed its investment on global financial markets using different financial products. This gives the argument to authors for starting the discussion on one longest living problem of market economies – corporate governance. This problem is not and should not be elaborated without putting it into the context of institutions that are responsible for minimizing the systematic risk as well as thinking on it out of the big geostrategic picture.

In this article with provocative title authors are discussing on layered problems that are immanent to all countries. They are elaborating one of the newest and yet not worldwide known accounting scandal case, but the one that is related to significant number of elements and influential groups. Authors are approaching problem from various aspects. At the beginning the case of conglomerate is put into the context of time, space and political moment. Following chapters discuss on the proportion of potential disaster and deficiencies in existing corporate governance mechanisms on micro and macro levels. At the end, instead of conclusion, authors try to give their critical views on what has been learnt from previous bankruptcies and what are potential ways of minimizing the systematic risk. Conclusion made by authors are done using various scientific methods where dominant role had inductive method, methods of analysis and synthesis, abstraction and generalization method and finally method of description.

II. HOW DID THE CONGLOMERATE GET TO BANKRUPTCY?

The conglomerate is the largest privately owned company in the Republic of Croatia and one of the largest companies in Southeast Europe. It operates mainly in five countries: Croatia, Slovenia, Serbia, Bosnia and Herzegovina and Montenegro but also with presence in Kosovo, Hungary, FYR Macedonia, Netherlands and Switzerland. Over the years the group became admired in society for the value it created and the power it has on Croatian economy. Conglomerate in 2015 counted more than 70 companies, employing more than 60.000 people with consolidated revenue of 7,44 billion USD. To put than number in prospective, the Croatian GDP in 2015 amounted to 51,84 billion USD. His main activities are agriculture, food production and retail so it could be considered vertically integrated company.

Conglomerate has its roots in 1976 when the current owner founded a private firm for the production of flowers and flower seedlings. In 1989, conglomerate was registered as a joint stock company, and by the end of Croatian war of independence in 1995 it owned some of the leading companies in the production of food and beverages and retail in the country. The acquisition of companies is made through a process of privatization of formerly state-owned enterprises. From 1992 to 1994 conglomerate acquired ownership of some of it's nowadays most important and valuable companies. Thus, the company has almost a monopoly in the production of ice cream on the market of the Republic of Croatia; it has a largest producer of edible oils, largest producer of mineral water, major producer of table salt and its own retail network in the country capital area. Through retail network, the group could distribute their products and other consumer goods. In this way, the company had the foundation for further growth and development. Soon after, the modernization of company started to accelerate and the conglomerate was registered as a holding company in 1995. By 1995, the company already grew to 10 companies. From 1995 to 1999, the conglomerate took over a major wine producer in state capital region and established now one of the biggest agriculture companies. The start of new decade has brought new important events in the company. It expanded its business activities from the capital to the rest of the Republic of Croatia, and the conglomerate started expanding to neighboring Bosnia and Herzegovina through establishing the branches and acquisition of existing companies. Expansion and growth occurred in that period coincided with 200 million USD loan which was granted to conglomerate from European Bank for Reconstruction and Development (EBRD). Such big borrowings will continue to track further business operations, so only two years later, on the Luxembourg Stock Exchange, 153 million USD was raised through the issuance of bonds. As a rule, after the borrowing, the company expanded by acquisition of companies or made investments in the existing ones. Every borrowing made in the international market was presented as a great success of the conglomerate. It expanded to the wholesale sector in 2001, and in 2003, the company also expanded to neighbor Republic of Serbia by purchasing largest company for production and distribution of ice cream and frozen food. Two years after the last long-term borrowing in 2002, the conglomerate is indebted for new 118 million USD by widening the existing corporate bond issue. This time, the company expanded into Hungary by purchasing bottling water company and ice cream company, expanding its retail business to Serbia and purchasing another companies in Croatia, among, which was the major producer of meat products, the biggest agricultural company in the region and one of the large wine and olive oil producer. In 2006, EBRD invested 130 million USD to equity capital, and next year conglomerate became market leader in food retailing in Bosnia and Herzegovina and became the majority owner of the biggest retail newsstand chain in Croatia. By the end of 2009, conglomerate increased its debt for additional 708 million USD and further expanded its business, this time mostly through investment in production lines and expansion of the retail and distribution network of existing companies and less through the acquisition of new ones. Of the aforementioned 708 million USD, 472 million USD refers to the issue of bonds in 2009 with a coupon of 10% for a period of seven years. By the end of 2009, the conglomerate had total long-term credit obligation of approximately 1,77 billion USD, while the total liabilities amounted 2,92 billion USD which was 76% of its assets. In the same year, the revenues of conglomerate reached 4,16 billion USD almost five times bigger than in 2002. Conglomerate had the same debt ratio in 2002, when the company's liabilities were five times less compared to 2009. At the beginning of the present decade, in 2010 conglomerate signed a 416 million USD loan for the restructuring of its balance sheet, while in 2011 refinanced its short-term credit debt for long-term while keeping the same debt ratio. In 2012, conglomerate continues to follow its business concept with new investments and increasing its debt, this time by concluding a financial arrangement of 826 million USD, but the debt ratio grows to 83%. In 2013, it has been preparing for the largest acquisition in its history and in 2014 it was realized by purchasing the biggest retail chain in the region for 642 million USD, which was financed by a 708 million USD loan through Russian state owned bank. The full effect of this purchase is present in 2015, from which it is apparent that the conglomerate revenue grew to almost 7,68 billion USD, an increase of 35% over the previous year. The merger of retail chain resulted in a debt ratio of 106%, which was evident only in 2017 through audited financial reports for 2015 financial year, while first financial statement in 2015, which were not real and objective, showed already high 86%. Regarding this change, in March of 2017, one of the biggest creditors of conglomerate, expressed doubt about reliability and accuracy of financial statements which was presented to investors and public in previous years. This turned to be true and highly anticipated audited financial statement of financial year 2016 restated total liabilities on 8,66 billion USD, a rise for 769 million USD. But even this undervaluing of liabilities didn't help conglomerate. The growth model based on high leverage and massive loans ceased to serve conglomerate at the beginning of 2017 when new information about the apparent problems in conglomerate began to emerge. At the beginning of 2017, Moody's downgraded conglomerate rating from B3 to B2 because of drop of operating performance [Moody's, 2017]. Two weeks later, conglomerate canceled a syndicated loan maturing in 2019. Without a new financial injection, the group found itself in financial problems and the exit from the situation was first sought in agreement with existing creditors (banks and suppliers). The government intervened and in April the government trustee took over the management of the conglomerate after the special law was enacted for this purpose. Events that followed brought political crisis that resulted in government reconstruction. Looking backwards, it is easy to see that the crisis has been emerging for years, and in the last 9 years the net profit of the company has been steadily falling, while the last three financial years conglomerate reported loss, with a constant increase of its debts in the same period. Reduction in profits limited the possibility of servicing debts, while the additional aggravating circumstance was a long recession in the Republic of Croatia, which maintained the level of the conglomerate's revenues at almost the same levels in the period from 2008 to 2010 and again from 2011 to 2013, only at a larger level. Big retail chain acquisition can also be seen as the last chance to reverse the negative trends of financial results and emerge from the situation, but this only increased the company's financial liabilities that eventually became too high. This purchase significantly boosted the conglomerate's revenues, and the first financial statements for the year 2015 in which the merger had full effect showed a total net profit of 184 million USD (although the real financial result according to 2017 audited financial statements was a loss of 567 million USD) and a high level of revenue of 7,68 billion USD. In 2016, revenue growth and synergic effects among companies were left out, resulting in a fall in credit rating, only the first step in the sequence of events, which later led of revealing company's unethical behavior in business regarding its financial statements.

III. THE PROPORTION OF POTENTIAL DISASTER AND WHO FAILED

A. Expanded view on conglomerate

Remarkable numbers in conglomerate should be elaborated in the broader context of time, space and political moment. It acquired some of its most valuable companies during the period of war and initial years of privatization that was considered to be one of the critical moments of contemporary economic history of country; not only because the war that resulted in significant loss for economy, but also because of privatization that shown many imperfections. These imperfections became obvious on some significant privatized companies that went out of market or reduced their activities, or through significant concentration of capital in the hand of couple of people or one person what was the case in conglomerate. Through the time concentration resulted in the rise of person importance and his tight relations with national governments. This is the reason why the Republic of Croatia could still be considered as a (post)transitional and not real market economy where the conglomerate case is showing the bad remains of inappropriate privatization process as well as questionable systems controls.

During time conglomerate made respectable relations with suppliers as well as customer and it became economically and consequently politically most relevant company in economy whose ownership structure was highly concentrated. Along with aforementioned numbers the importance of conglomerate is obvious from the fact that it is now using 4,5% of state owned farmland or 0,58% of total state area. The non-controlled bankruptcy was not an option when it was obvious that conglomerates sources of financing disappeared. High exposure to risk of failure of significant number of companies and consequently potential macroeconomic and social instability resulted in Law on extraordinary management process in the systematically important companies that represent a special version of insolvency law whose purpose is to give additional time to systematically important companies to arrange the settlement with creditors.

B. Dealing with wrong numbers

Most common means of communication with company stakeholders are financial reports with their explanatory notes and management discussion and analysis chapters. Last conglomerate's financial reports were disclosed in 2016 and related to fiscal year 2015. Since then only non-audited quarterly reports were disclosed periodically since October 2017. In April 2017 when new Law was enacted, there was a reasonable doubt about reality and objectivity of last presented audited financial reports. Existing auditor has been changed and new one engaged to audit financial reports for 2016 as well as for comparative 2015. Findings of new auditor confirm the doubts about reality and objectivity of financial statements positions presented for fiscal year 2015. Figure 1 presents the main findings in balance sheet and the differences between first disclosure of financial statement for 2015 and adjusted values after auditor was replaced. Main differences relates to liabilities that has been underestimated for 1,499 billion USD as well as total assets that has been overestimated for 116 million USD. This fraudulent financial reporting has been reflected in total capital overestimated for 1,615 billion USD.

As a reflection of some of the balance sheet positions wrongly estimated, irregularities were shown in income statement as well (Figure 2). Operating revenues were overestimated for 256 mil USD while operating expenses were underestimated for 421 mil USD, both resulted in profit overestimation for 739 mil USD.

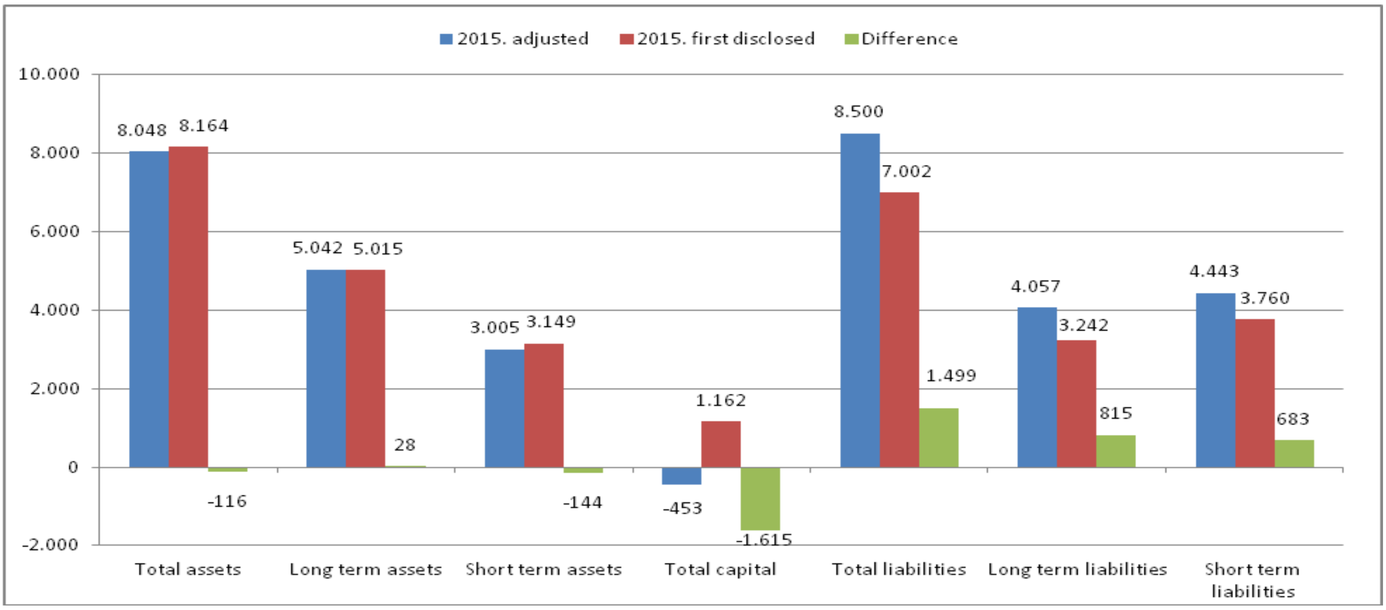


Figure 1. Balance Sheet Positions Of Conglomerate In Mil USD

Source: Conglomerate financial statements

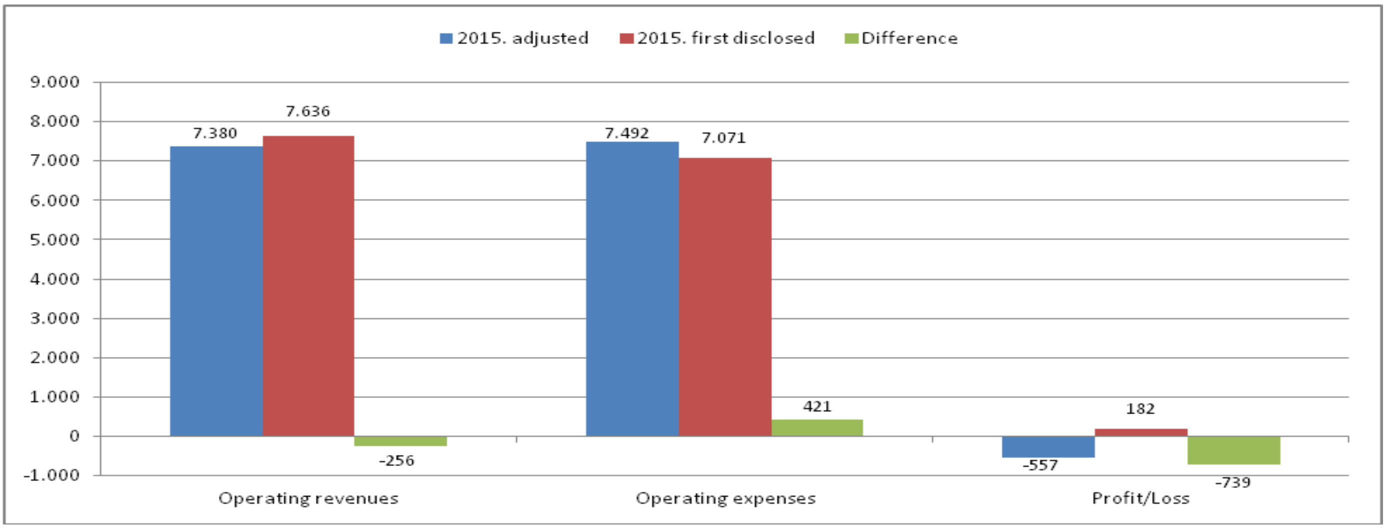


Figure 2. Income Statement Positions Of Conglomerate In Mil Usd
Source: Conglomerate financial statements

Conglomerate fraudulent financial reporting could be classified in three groups:

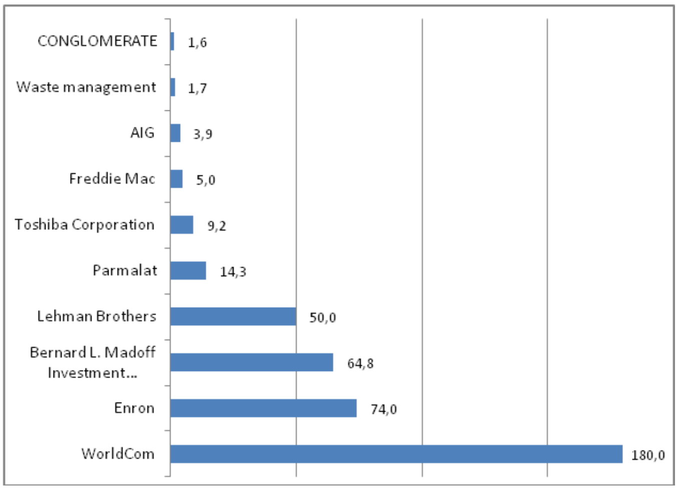
- Accounting irregularities,
- Write-offs (value adjustment) and
- Other influence on capital.

Accounting irregularities consisted of nondisclosure of operating and financial expenses. These expenses were recorded in accounting books but not disclosed in financial statements and they had to be related to initial public offer (IPO) of conglomerate that never appeared. Only one proportion of mentioned costs was really related to IPO. Other part was not and the total amount of these non-disclosed costs that appear in the period from 2010 to 2015 amounted 350 mil USD. Second accounting irregularity included non-disclosure of liabilities from loan that amounted for 448 mil USD. These liabilities were recorded in accounting book but not disclosed in financial reports. Another 155 mil USD of liabilities has been inappropriately classified like capital reserves as well as last most significant irregularity that include wrong classification of given loans and deposits as a cash and cash equivalent improving the liquidity view of conglomerate for amount of 403 mil USD.

Write-offs include value adjustments that were done primarily on intangible assets – goodwill and brand values (232 mil USD), inventories and other assets (433 mil USD) and loans and receivables from other parties (62 mil USD). Other influence on capital resulted in amount of totally 410 mil USD.

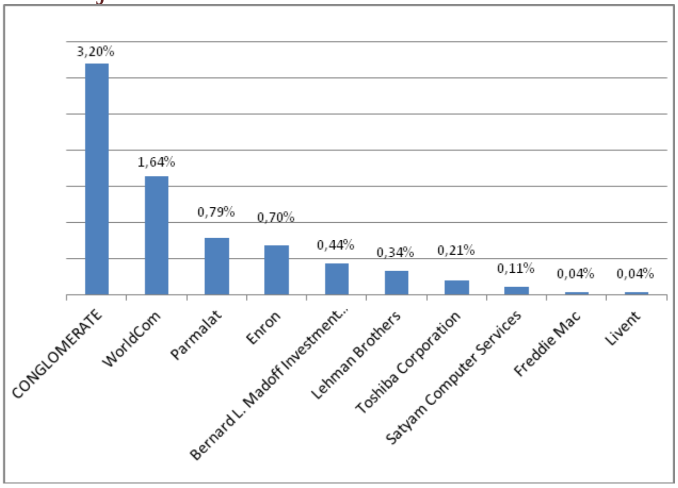
Looking on the numbers in the context of most known and valuable contemporary frauds that are presented in Figure 3 conglomerate is among the top 10 fraud scaled by value of damage. Although it is far away from top 5 frauds its value has to be viewed in relation to economy in which it operates what is shown in Figure 4. Fraudulent financial reporting that appears in conglomerate as a percentage of GDP is twice bigger than proportion of the biggest fraud ever and four times larger than one in Europe.

FIGURE 3. ESTIMATED FRAUD LOSS OR DAMAGE IN USD



Source: Conglomerate financial statements, http://www.accounting-degree.org/scandals/

FIGURE 4. PERCENTAGE OF FRAUD LOSS IN GDP



Source: Conglomerate financial statements, http://www.accounting-degree.org/scandals/

Seriousness of situation is proven by worries of governments in neighboring countries because of the possible collapse of conglomerate and the adverse consequences for the economy in those countries where it operates and owns property. Another political or economic problem consists in debt exposure to Russian bank that seems to be excluded from settlement agreement while new investment funds from western countries get into the game what makes the conglomerate case interesting from geostrategic point of view.

C. How did the control mechanisms work?

Becoming "too big to fail" with proportion of revenues that reached 14% of national GDP and through the chain of suppliers as well as customers that are significantly exposed and related to conglomerate not many questioned its sustainability although information about significant prolongation of liabilities payments existed. Logically there is a crucial question that arises: How did the control mechanisms work?

Control mechanisms try to prevent, discover and correct the irregularities that could appear or already exist in a company. They could be elaborated on micro level or the level of the company, where system of internal control and good corporate governance practice should be implemented, and on macro level or level of institutions that supervise the economy as a whole. Most of irregularities relate to non-intentional ones that are discovered and corrected but there are a proportion of irregularities that relates to fraud and appear in most cases as asset misappropriation, corruption and fraudulent financial reporting. For the moment it has been proven that irregularities of conglomerate relate to fraudulent financial reporting where management "cooked the books" and disclosed unreal and non-objective financial statements.

Controls on micro level in the conglomerate were inappropriate and were the result of management style that was generally autocratic and centralized. This characteristic of management that was mainly concentrated in the hand of one person who is the major owner of conglomerate was closely related to formation of management of companies inside the conglomerate as well as their supervisory boards where supervisors were named by the same person who has to be supervised. The main question is did the supervisory boards have appropriate information and did they ask for appropriate information. According to Company law supervisory board has the responsibility to company not to shareholders what is often forgotten.

Controls on macro level include control bodies outside the company. Major and first line macro control mechanisms are the auditors. The objective of auditors is to give opinion on financial statements reality and objectivity by performing intensive audit tests. Information presented in previous chapter shows that auditors failed to fulfill their role in modern economy by not recognizing the fraudulent financial reporting. The IFRS/IAS allow a certain amount of flexibility in their appliance through the alternatives offered, but as long as the financial statements are in accordance with the accounting standards (according to auditor's opinion) there is no reason to doubt about their fairness. Or did we just mean that? Management of the business entity is selecting and paying the auditor, so no additional conclusions are needed.

There are another three bodies whose role in assuring control could be analyzed deeply and is debatable. First one is Croatian Financial Services Supervisory Agency (Hanfa), a supervisory body whose scope of activities and competence cover the supervision of financial markets, financial services and supervised entities providing those services. Hanfa exercises supervision of business operations of stock exchanges and regulated public markets, companies authorized to provide investment services and perform investment activities, investment firms and securities issuers, brokers and investment advisors, tied agents, central clearing and depository company, insurance and reinsurance companies, insurance and reinsurance intermediaries, investment and pension fund management companies, pension insurance companies, investment and pension funds, Central Register of Insured Persons, Fund for Croatian Homeland War Veterans and Members of their Families, Retired Persons' Fund and legal persons carrying out leasing and factoring operations unless they are provided by banks as part of their registered activities [4]. Within the scope of this institution is, besides other scopes, supervision over the operations of securities issuers, but primarily the emphasis is on the transparency control, which is not disrupted until all formal requirements for issuing securities are compiled. Its role in supervising becomes emphasized after the problem of bills of exchange appeared. Conglomerate issue billions of USD in bills of exchange and many suppliers who owned them sell them to factoring companies but with option that factoring company could claim the total sum of bill of exchange from suppliers if the issuer cannot repay them.

Second body whose role has been emphasized is Croatian National Bank whose primary objective is to maintain the price stability and stability of financial system as a whole. This objective is done by using various instruments but one that is important for conglomerate case is supervision of credit institutions and their operations. However, neither from the Croatian National Bank there could not be expected any warnings or reactions because primary monitoring is aimed at banks rather than business entities. On the other side the monitoring had to be focused on banks' exposure toward one or related group of entities.

Third body that represents the institutional system of control is Financial Stability Council. It is the inter-institutional body that designs the macro-prudential policy of the Republic of Croatia. It consists of representatives of the Croatian National Bank (HNB), the Croatian Financial Services Supervisory Agency (Hanfa), the Ministry of Finance (MF) of the Republic of Croatia and the State Agency for Deposit Insurance and Bank Rehabilitation (DAB). So, the question arises whether the Financial Stability Council could react. It is composed of representatives of the aforementioned institutions and one of it's' task is to identify, assess and address systemic risks, while the fact is that this is a threat to the systemic overflow of problems from the conglomerate to Croatian economy

The supervision role of three bodies in analyzed case could be questionable, particularly in the context that the amount of transactions done by conglomerate was enormous. Considering the fact that conglomerate influence in economy and politics was enormous and any action related to conglomerate was very sensitive the question on timing and intensity of reaction of three supervisory bodies is debatable.

Stocks of individual companies within the conglomerate were listed on the stock markets and comparison of their market value with the information contained in the financial statements should point to the upcoming or already existing problems.

The question is also whether the Tax Administration representatives could see and point out irregularities, but their attention is mainly focused on the analysis of financial statements items that are important for determining the tax base. Mostly through media debate, but certainly in the awareness of the citizens themselves, there is a question how it is possible that none of the mentioned regulators has not pointed at, or at least noticed irregularities that have been going on. An insight into conglomerate's audited report makes a question whether or not there are the same or similar situations in reports from other Croatian business entities?

IV. WHAT DID WE LEARN AND WHAT IS STILL TO STUDY ON?

A. Failure of control mechanisms and/or failure of ethics

Previously mentioned Law on extraordinary management process in the systematically important companies has certainly delayed the effects of this crisis on GDP falling, employment, possible credit rating, but there is still question if this crisis could be avoided at all and whether the context of making law was politically or economical?

From the aforementioned, it is obvious that the control mechanisms failed. But at the same time some fundamental ethical principles of doing business have been ignored by accountants and managers too.

If it is clear how the control mechanisms failed, it still remains unclear why the accounting profession has allowed such situation to happen? According to the Code of Ethics for Professional Accountants [14], the principle of fairness (Section 110) imposes an obligation on all professional accountants to be sincere and honest in all professional and business relationships. Accountant will not be consciously connected with information sources for which he/she believes that omit or distort information that should be included and where such omission or distortion would lead to misrepresentation. Taking into account all above-mentioned facts of the distorted image of a conglomerate business, we can conclude that in this case the principle of honesty is questionable. Besides that, principle of professional behavior (described in section 150 of Code) according to which it is necessary to act in accordance with relevant laws and regulations and to avoid any actions for which accountant knows or should know that will ruin professional reputation, is also questionable.

However, it is not just the ethics of accountant questionable but also the ethic of business entity management. By selecting accounting and financial reporting policies management directly affects the quality of information contained in the financial statements of a business entity.

Manager's responsibility of financial reporting is based on IAS 1, IFRS and the provisions of EU Directive 2013/34. Financial statements are a public document, which is also evidence of the necessity of ethical management behavior in terms of financial reporting. Besides that, financial statements themselves represent one of the instruments for quality control of business decision-making on management and the protection of creditors' interests. The fact that in certain circumstances there is a lack of confidence in the relationship between users of financial statements, management and independent auditors due to the conflict of interest poses a potential threat to the quality of the financial statements. That is what happened in this case – confidence in the accountants, auditors and control mechanisms has been broken, ethical principles are disrupted.

The case of conglomerate has shown that control mechanisms on micro level failed. Supervisory boards as well as auditors did not fulfill their role in protecting the interest of company i.e. interest of all stakeholders. Although the company ownership is highly concentrated, its high leverage ratio and significance for country and broader region makes number of stakeholder quite big. Bondholders, credit institutions, factoring companies, suppliers, customers, employees, state as well as society as a whole are important stakeholders who are interested in conglomerate activities. Concentration of ownership and consequently autocratic and centralized decision making system resulted in formation of supervisory boards that did not perform, if even perform, the supervising activities in proper way.

Problem existed on macro level control mechanisms as well. Bodies that are in charge of control failed to react properly. Their reaction was weak and non-coordinated. Auditors were highly exposed to conglomerate earning significant proportion of their revenues from companies – members of conglomerate making its independence questionable.

Above the legal issues related to conglomerate that will last for probably for decade or more, as experiences from countries from surrounding and similar legal systems has shown, there arises the ethical problem that is typical for both levels of control. This problem exists on the level of an individual who is willing to stay passive and does not react although it should. The problem could be partially described by quality of legal system that does not properly react on illegal behavior giving to individual signals that it is acceptable. On the other side the sources of the problem are dominant values of individuals who sometimes are willing and/or are pressured to behave in unethical manner. Here we are talking about motives/pressure as an element of fraud diamond.

B. *How to improve corporate and state governance or how to become ethical society*

Improving governance on micro and macro level are challenges that are faced through centuries. World standard and quality of life have never been on such a high level as they are today as well as systems of corporate and state governance. But the problem exists in distribution of wealth and consequently quality of life among population inside and among the countries. Huge wealth and income differences among population affect the stability of society and often open the ethical questions on how these differences appeared. State governance is crucial factor whose main role is to bring laws and afford legal stability and effectiveness of the state assuring in this way the security of citizens. The problem is more intensive on level of corporate governance where individuals involved in this process sometimes do not represent law abiding citizens and the legal system does not react properly although the laws exist. Here the problems of legal system effectiveness exist that are typical for analyzed state. So what are the potential solutions of these problems? Improving the legal system by strengthening the supervising institutions, raising the level of law and economic education, pressuring the state and local authorities through various democratic procedures are just couple of suggestions that should be implemented in young (post)transitional country like one that is analyzed. Or the new control mechanisms could be established that will supervise "to big to fail" companies that operates out of financial sector. No matter which approach will be applied the initial challenge will always exist: who are the individuals that will perform the control.

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