CREATIVE ACCOUNTING: WHEN IT'S TOO GOOD TO BE TRUE

By Prof. CA. Reshmi M Gurnani

(FCA, M PHIL, MCOM, PGDBM)

Abstract

The term 'creative accounting' can be defined in a number of ways. Initially we will offer this definition: 'a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business'. Engaging in creative accounting is a possible first step towards pushing at the boundaries of the law. The danger is that respectable executives lose sight of where the boundaries are, and end up committing fraud.

There are many ways in which public companies can creatively manipulate their income statement, from modifying revenues themselves, to creatively classifying income, to utilizing misleading pro-forma income statements. While these practices are often legitimate, as long as they are not abused, investors should dig a little deeper for some real peace of mind.

This paper explores the nature and incidence of creative accounting practices within the context of general considerations. It explores several definitions of creative accounting, discusses the various ways in which creative accounting can be undertaken and the range of reasons for a company's directors to engage in creative accounting. The paper also captures the role of the statutory auditor in the whole scene as one of the possible solutions for the creative accounting problem.

Keywords *Creative Accounting, manipulation, frauds*

Introduction

Creative Accounting is a process in which a company firstly estimates its "target" financial position, and then works backwards in order to achieve these desired figures. This process, also referred to as "cooking the books" is sometimes used as a means of manipulating the true incomes and losses of companies.

The term as generally understood refers to systematic misrepresentation of the true income and assets of corporations or other organizations. "Creative accounting" is at the root of a number of accounting scandals. The idea of Creative Accounting, Cosmetic Accounting or Profiteering is not a new concept to the accounting world. Manipulation of accounts done in one year often requires the same kind of tailoring to be made the next year too and thus the process is constant. The practice often throws financial reporting out of control eventually results in frauds of very large magnitude.

Thus in simple terms, Creative Accounting refers to the use of accounting knowledge to influence the reported figures, while remaining within the jurisdiction of accounting rules and laws, so that instead of showing the actual performance or position of the company, they reflect what the management wants to tell the stakeholders.

"Purposeful intervention in the external financial reporting process with the intent of obtaining some exclusive gain".

"Creative accounting is the transformation of financial accounting figures from what they actually are to what preparer desires by taking advantage of the existing rules and/or ignoring some or all of them".

Research Methodology

1 Aims and Objectives

The aims of the paper are

• To get the knowledge about Creative Accounting.

• To know the How, Why and When of the Creative Accounting.

• To study the role of Statutory Auditor in this regard.

2 Scope and Limitations

The scope of this study is to examine the theoretical aspects of the Creative Accounting and related laws in Indian perspective, as the study is purely based on the secondary data. In this regard the provisions of law have been dealt with only so far as was important in understanding the underlying principles and enumeration of any model has been sought to be avoided.

3 Method of Writing

The researcher has attempted to adopt an analytical and exploratory approach. The method adopted is analytical in so far as it seeks to understand the meaning and basic functioning of Creative Accounting.

4 Research Questions

1. What is the Meaning and Definition of Creative Accounting?
2. What are the different reasons for doing Creative Accounting?
3. What are the possible methods and situations for Creative Accounting?
4. What can be the role of Statutory Auditor in this regard?

5 Sources of Data

The present study is of descriptive nature based on secondary data collected mainly through various newspapers, magazines, official websites, published research papers, journals, books, ICAI guidance notes and various reports of research studies.

Discussion

1 Meaning and Definition of Creative Accounting

Creative accounting, also called aggressive accounting or innovative accounting, is the manipulation of financial numbers, usually within the letter of the law and accounting standards, but very much against their spirit and certainly not providing the "true and fair" view of a company, that accounts are supposed to show. A typical aim of creative accounting could be to inflate profit figures. Some companies may also reduce reported profits in good years to smooth results. Assets and liabilities may also be manipulated, either to remain within limits such as debt covenants, or to hide problems.

A different definition from the perspective of an accountant would be "The accounting process consists of dealing with many matters of judgement and of resolving conflicts between competing approaches to the presentation of the results of financial events and transactions... this flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities - practised by the less scrupulous elements of the accounting profession, have come to be known as creative accounting".

2 Why Creative Accounting

The managers are motivated for fixing financial statements for either managing positions or profits. Following are the most common reasons for creative accounting:

- To meet internal targets.
  The managers want to cook the books for meeting internal targets set by higher management with respect to sales, profitability and share prices.
- Meet external expectations.
  Company has to face many expectations from its stakeholders. The Employees and customers want long term survival of the company for their interests. Suppliers want assurance about the payment and long term relationships with the company. Company also wants to meat analyst's forecasts and dividend payout pattern.
- Provide income smoothing.
  Companies want to show steady income stream to impress the investors and to keep the share prices stable. Advocates of this approach favour it on account of measure against the 'short-termism' of evaluating an investment on the basis of the immediate yields. It also avoids raising expectations too high to be met by the management.
- Window dressing for an IPO or a loan.

The window dressing can be done before corporate events like IPO, acquisition or before taking a loan.

- Taxation

  The creative accounting may also be a result of desire for some tax benefit especially when taxable income is measured through accounting numbers.

- Change in management

  There is another important tendency of new managers to show losses due to poor management of old management by some mismanagement in provisions.

3 Ways or Methods of Creative Accounting

The incidents of creative accounts are fairly common. These Accounting methods can broadly be categorized in the following four ways:-

- Sometimes the accounting rules may allow a company to choose between different accounting methods. In many countries, for example, a company is allowed to choose between a policy of writing off development expenditure as it occurs and amortising it over the life of the related project. A company can therefore choose the accounting policy that gives their preferred image.

- Certain entries in the accounts involve an unavoidable degree of estimation, judgement, and prediction. In some cases, such as the estimation of an asset's useful life made in order to calculate depreciation, these estimates are normally made inside the business and the creative accountant has the opportunity to err on the side of caution or optimism in making the estimate.

- Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. This is achieved by entering into two or more related transactions with an obliging third party.

- 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 of Rs. 100 Crore at historic cost which can easily be sold for Rs. 500 Crore, 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.

4 Situations where Creative Accounting may be resorted to

- During Mergers & Acquisitions;
- To hide poor results or boost EPS;
- Capitalising R&D or Revenue Expenses;
- Depreciation – Overcharging or Undercharging;
- Revenue recognition;
- Asset sales;
- Failure to write down inventories that have declined in value;
- Reflecting higher margins.
- Off-balance sheet financing;
- Valuations – particularly of intangible assets such as Goodwill and brand names.

5 Role of the Statutory Auditors

The statutory auditors have an important role to play in checking and restraining creative accounting. The auditors are appointed by the actual owners – the shareholders, and should ensure they protect the interests of all stakeholders. Audit is in the nature of due diligence hence assumes great significance. The laid down standards and other guidelines have to be followed not just in letter but in spirit also. Role of auditors and their liability also needs to be enhanced to check the propriety of financial transactions of a company.

Auditors need to follow appropriate auditing standards with competence and integrity and to give the independent opinion that is appropriate to the result of his work. Because it is objective and independent, the auditor's opinion adds credibility to the reported information, thereby facilitating its use by shareholders and others.

At the same time the statutory auditors who have failed in their duties or have ignored the warning signals need to be brought to book. The current punishment prescribed u/s 227/233 is not sufficient as deterrence and the complaints filed in the ICAI take an unusually long time to be decided and defeat the purpose of deterrence, so some serious and imposing punishment should be set for erring auditors.

Conclusions

To sum up the discussion on creative accounting practices, it is an unfortunate situation that we cannot completely restrict or stop the misuse or abuse of creative accounting practices. The improper use of such creative accounting practices had fooled both auditors and regulators in the past (e.g. Enron, Bank of Punjab, Satyam etc) and it continues to do the same. The complex and diverse nature of the business transactions and the latitude available in the accounting standards and policies make it difficult to handle the issue of creative accounting. It is not that creative accounting solutions are always wrong. It is the intent and the magnitude of the disclosure which determines its true nature and justification.

But, the good news is that in recent years, a number of nations have taken steps to minimize the incidence of creative accounting by implementing regulations that make it more difficult for businesses to cook the books and present a financial position in a way that is does not tell the entire story. The hope is that by doing so, investors will be able to obtain all the data required to make an informed decision about their investment options, and prevent the economy from being adversely affected by misleading financial accounting practices at major corporations. Since there are a number of ways to engage in creative accounting, chances are it will take a number of years to craft regulations that will make those unorthodox accounting processes explicitly illegal.

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Bio

CA. (Mrs.) Reshmi M. Gurnani, Asst. Professor in Accountancy Department in Smt. Chandibai Himathmal Mansukhani College, Ulhasnagar.