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RESEARCH ARTICLE

EMPIRICAL STUDY OF ACCOUNTING PRACTICES:CREATIVE ACCOUNTING

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ABSTRACT

Creative accounting a euphemism, referring to process of maintaining books of accounts by the rules of standard accounting practices to reap the desired results. The study has been conducted to get a detailed view of accounting practices adopted by companies in India which fall under creative accounting. It also examines the motives and reasons of adopting such fraudulent practice by companies. It has also observed that continuous use of accounting distorts the basic objective of preparing accounts and financial statements and threatens the integrity of financial reporting. Accordingly, a brief description of practices adopted by different Indian companies viz Asian Electronics Ltd, Hindustan Zinc Ltd, ONGC Ltd, CRB Capital markets Ltd etc has been shown. The paper concludes with the analysis of possible solutions for the creative accounting problem.

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INTRODUCTION

Every enterprise for the achievement of its objectives performs various monetary and non monetary transactions which are timely maintained in the books of accounts and records. Accounting is required to account for these resources. Accounting also known as the language of business serves as a means of communication. Financial statements are one of the most important businesses to reveal their performance and status to investors, regulators &employees alike. (Elliott *et al.*, 2005) Financial statements generally provide information about the financial performance, financial position, and changes in financial position which are useful to a wide-range of users in making significant investment and other economic decisions. Financial statements are bound by laws and accounting standards. Financial statements which are supposed to fulfill the principles and regulations of accounting standards when are distorted to enhance the apparent performance of the firm is categorized under creative accounting. Creative accounting is a process in which a company alters the accounting in order to achieve the desired results. The process also referred to as "cooking the books" is sometimes used as means of manipulating the true income & losses of companies. Creative Accounting also referred as earnings management involves adopting such practices by companies which will help them show a favorable financial position to their stakeholders (Healy and Wahlen, 1999). The term 'Creative Accounting' came to prominence in a book published by 'Ian Griffiths' in 1986 called creative accounting.

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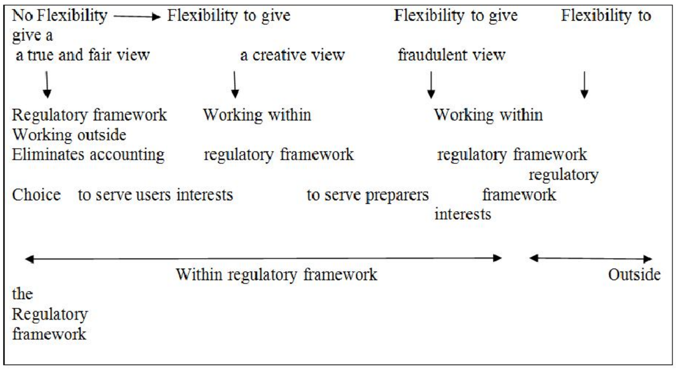
Definitions of Creative Accounting

A process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of business. (Amat, Blake and Dowds, 1999) *"Creative accounting is the transformation of financial accounting figures from what they actually areto what preparer desires by taking advantage of the existing rules and/or ignoring some or all of them". (Kamal Naser, 1993:2)* Involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared. (Copeland, 1968) "Any & all steps used to play the financial numbers game, including the aggressive choice & application of accounting principles, both within &beyond the boundaries of generally accepted accounting principles &fraudulent financial reporting. Also included are steps taken forward earnings management & income smoothing."(Mulford and Comiskey 2002, p.15) Creative accounting methods are noteworthy because they remain in use as generally accepted accounting principles, even though they have been shown to be deceptive in many cases (Metcalf, 1977, pp188). 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…………this deception is all in perfectly good taste. It is legitimate. It is creative accounting. (Griffiths, 1992, pp 1)

Creative accounting has became popular in financial market, whereby the companies are manipulating the financial statements through various techniques of it in order to reap desired results. It is hence meant to serve the preparers interest by exploiting the loopholes in the current regulatory system. Loopholes exist because of flexibility in the regulatory system.



Source: Adapted from Jones (2006)

Fig shows there is a continuum from no flexibility to flexibility to give a true and fair view to flexibility to give a creative view to flexibility to give a fraudulent view. The fundamental objective of books of account of a company is to provide a true and fair view of company to the end users. Despite the existence of accounting system number of companies rearrange the accounts which may undermine the accuracy and reliability of financial statements. When the managers/ authorities refrain from this objective and does not comply the regulatory system, eventually uses creative accounting to fulfill their requirements. A regulatory system varies from country to country. To regularize the accounting standards and bookkeeping national, international standards ,company law, independent accounting commissions (such as Securities and Exchange Commission in the U.S.A) has therefore grown up to deliver a true and fair view to account users. (Jones M) Thus if there is no flexibility there will be no creative accounting.

Objectives of Creative Accounting

1. To study the nature and incidence of creative accounting
2. To study reasons of practicing creative accounting.
3. To study different methods of practicing creative accounting

Review of Literature

The literature on Corporate Accounting Frauds is very extensive. Different academics have drawn up varied conclusions to explain Reasons and Results of creative accounting. Creative Accounting involves the manipulation in the books of accounts, concealments of facts & figures to get unfair advantage. Accounting has been defined as “the art of faking a balance sheet” (Bertolus J.), “the art of calculating the benefits” (Lignon M.), “the art of presenting a balance sheet” (Gounin L.), or “the art of saving money” (Ledouble D.). Accounting figures are recorded in books of accounts by applying general accounting rules. Accounting ‘creativity’ is often needed to show the ‘true and fair view’ of corporate performance, but taken to extremes it can result in another Satyam. Trotman (1993) defines creative accounting; appreciating that it is a communication technique having in view the amelioration of the information provided to the investors. Thus, the economic entity is presenting to the investors or to the prospective investors financial statements passed through the filter of some techniques capable of generating a more favorable image on the market but also the illusion of some more attractive results that the normal. Shah *et al*. (2011) explained why managers do creative writing and how they become successful in performing such practices in the presence of stringent rules and procedures. They also explored whether creative accounting practice is good for the companies or bring crisis in the company. It has been seen that companies which are more prone to such fraudulent financial reporting practices are those with weak internal controls, having no or weak audit committees, majorly family owned businesses and board of directors have significant equity ownership (Bloomfield, 2002; Hirshleifer and Teoh, 2003). Creative accounting has been defined by various names in various countries. In India, the term is more frequently used as Earnings Management or Creative Accounting. In the literature, creative accounting can still be found under the name of *income smoothing, earnings smoothing, cosmetic accounting or accounting cosmetics, financial crafts or accounting crafts*, *financial engineering*.

Motivation of creative Accounting

Fiserova has explained creative accounting in context of joint stock company that how they show fiction statement than reality to take a loan they show higher value of assets, low profit again at the time of paying tax to the government and again profit increases at the end of the year when information is to be given to shareholders. It can be analysed that the creative accounting provides benefits in the form of avoiding or reducing the potentially sharp drop in share price, an upward move in the firm’s share price. Rewards of the creative accounting may be desire to improve debt ratings or to lessen the cost of borrowing or reduce the restrictions from debt covenants. Investor shareholders intend to get more divided and profits on share price, other benefits may come by reducing the political costs or to collect more taxes etc.

Category	The Objectives & Benefits Companies Trying to Achieve
Share –Price Effect	Higher Share Price Reduce Share Price Volatility Increase Firm Value Lower Cost of Equity Capital Increased Value of Stock Options
Borrowing Cost Effects	Improve Credit Rating Lower Borrowing Costs Relaxed or Less Stringent Financial Covenants
Management Performance Evaluation Effects	Increased Bonuses based on Profits/Share Price
Political Cost Effects	Decreased Regulations Avoidance of Higher Taxes

Source:The Financial Number Game by Charles W. Mulford & Eugene E.Comiskey,2002 (John Wiley & Sons)

With a widespread accounting systems in different countries companies gets lots of opportunities to go for creative accounting Creative Accounting help companies spread a huge gain over several accounting periods, put off recognising losses for as long as legally possible and, in some cases, selectively ignore accounting conventions that might decrease the value of share price in stock market .In spite of number of checks and balances required by regulatory agencies, there have been number of accounting scandals in India. Corporate frauds are results of manipulation of accounts and accounting 'jugglery' designed to deceive others for wrongful gains. Such creative accounting by 'fudging' the accounts is attributed to the flexibility provided by the accounting system. (Jones, 2011) Creative accounting has led to a number of recent accounting scandals, and many proposals for accounting reform that centred on an updated analysis of capital and factors of production that would correctly reflect how value is added (Osisioma and Enahoro, 2006). According to Noble Group, 2009, one in five of the BSE 500 companies on the Bombay Stock Exchange has accounting problems, largely because basic checks on a promoter are either weak or have conflicts of interest. In a report developed by India Ratings and research suggest that the discreprency in reporting financial numbers increases as the promoter holding in the company increases. The study finds that companies with over 50% shareholding by promoters are more likely to misstate their accounts in order to impress the markets. Ways are devised to hide the true picture and show an improved performance of the company. It may adopt various methods to gear the financial statements and show a rosy picture of the company by superficially increase the receivables and inventories to raise working capital loans or long term loans. The companies inflate the fixed assets values to raise more loans or raise money by issue of debentures. There may be fictitious receivables or cash on books which due to very large scale operations may not be detected in sampling methods. In a report of Noble Group (a UK based investment bank), where accounting practices of some 313 BSE 500 companies were studied. 63 BSE 500 financial sector companies were excluded because they do not lend themselves to the forensic accounting techniques used and 124 companies were excluded because their consolidated financial statements for the last two financial years were not available. According to the report, the sectors where creative accounting was the most popular in 2007-08 were housing, including firms related to real estate, construction and cement, information technology and capital goods(such as companies in construction and power T&D and materials. In 2008-09 there was a shakeup in the defaulter list. Healthcare replaced IT among the worst performers. Also, the top 50 stocks in the BSE 500(by market capitalization) were the most likely segment of the market to have a company in Nobel's Creative accounting "blacklist of the 50 worst companies "for 2008-09.

Industry Sectors Using Creative Accounting in India

Sector	Per cent of 50 worst companies	Probability of fudging books (in per cent)
Housing Related	16	25
Healthcare	12	21
Capital goods	10	14
Metal, metal products and mining	10	21
Information Technology	8	12

(Source: Raj, Rakesh (2010), "BSE's Top 50 may be worst at Accounting," Business Today,
January 21, 2010 available at www.businesstoday.intoday.in)

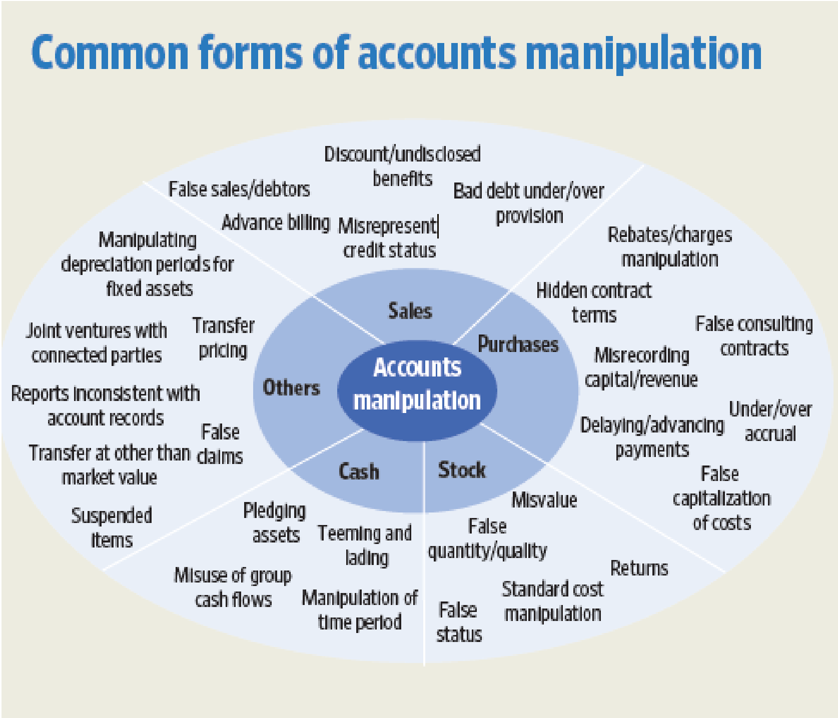
In 2008-09, the rupee depreciated over 25 per cent, and corporate India's external debt went up by 20 per cent. Companies could have charged the depreciation losses to the profit and loss account; or, spread it over a few years, Reliance Communications (RCom) t neutralised the adverse effect on its profit by transferring an equal amount from its General Reserve (accumulated profits earned in past years). Experts disapproved later when exchange rate got appreciated and profits rose. It was violation of rules setting off exchange losses against the General Reserve is by no means allowed; Companies often use amalgamations that have been approved by the court to write off losses against reserves or the share premium account. Creative Accounting is not different in India also. Following table shows a list of company and nature of fraud from India, indulged in manipulating the accounts to derive the

Accounting risk may be different for different financial statements. In respect of the profit and loss account, the accounting risk is usually the overstatement of income and understatement of expenses. For the balance sheet, it may exist in three areas: the correct valuation of the company's assets, accounting for all liabilities, and over- or understatement of net worth. Similarly valuations of an asset on the balance sheet might also differ. Valuation methods for stocks, choice of depreciation method and decisions on the capitalization of expenses related to fixed assets can affect reported profits. The basic objective of balance sheet to provide true and fair view is The effect of creative accounting may thus defeat the very purpose of presentation of 'true and fair' financial statements. It should be stressed that these companies have done nothing illegal but merely used the flexibility permitted by Indian law

Creative Accounting and Fraudulent Practices followed by the Indian Companies

Company	Years	Nature of Fraud
WIPRO Ltd	1996-97 to 1999-2000	Transfer of land to stock creating capital reserve with the fair value and using it to neutralize the effect on profit of reduction of land value
Bombay Dyeing & Manufacturing Company Limited	2003-04 & 2004-05	Creating provisions for possible loss on firm purchase contract and subsequent write back of such provision thereby converting operating losses into operating profit.
Larsen &Tourbo Limited	1999-2000 and 2001-02	Income recognition through transfer of loan liabilities at a lower consideration.
Apollo Tyres Ltd	2004-05	Debiting profit and loss account with additional excise duty payable to the government and transferring equivalent amount from general reserve to neutralize the effect.
Asian Electronics Ltd	2004-05	Impairment of assets: treatment of deferred tax
Oil and Natural Gas Commission, Mukund Ltd., Torrent Power ACE Ltd and Tata Motors Ltd	2004-05	Capitalization of interest through transfer of loan liabilities at a lower consideration
Hindustan Zinc Limited	2003-04 & 2004-05	Reclassifying assets in the balance sheet
Tata Motors, BombayDyeing, Mahindra and Himachal Futuristic	2001-02	Direct write –offs from reserves
Satyam Computers Services Limited	2008-09	Fraudulently incorporated a nonexistent cash component by inflating the bank balances, fudging bills, accounts receivables, interest, and liabilities

Source: Jones (2011) 'Creative Accounting, fraud and international accounting standards.'John Wiley& Sons, London, page 235



Source: KPMG in India's Fraud Survey 2010
http://www.livemint.com/r/LiveMint/Period1/oldpdf/ed629b09-bce0-48b6-a633-3ea44a8b11a0.pdf

to present their view of their companies' financial statements. Creative accounting techniques include Manipulation of expenses, Overstatement of revenue, Overvaluing assets, Delaying payments, Off balance-sheet finance, Tampering taxation, Acquisition Goodwill, Leasing transactions, Capitalization of Research and Development Expenditure, Depreciation Policy changing, Inventory, etc. The 10th biennial India Fraud Survey Report 2010reveals that 81% of the companies surveyed felt that financial statement fraud was the biggest threat in India, with at least 60% of them saying inadequate enforcement of regulations had increased such fraud. In July 2014 report prepared by India Ratings, that companies even in the top hundred of BSE 500 companies could be involved in creative accounting practices. A list of other financial frauds comprises the name of CRB Scam (1996) where Chairman of CRB Capital markets Ltd was accused of taking off Rs.12 billion in the CRB scam by using its State bank of India's accounts to siphon off the bank funds by encashing interest warrants and refund warrants. In case of Home Trade (2000) Eight Co-operative banks like Valsad People Co-operative bank, Navasari Co-operative bank from Gujarat lost around Rs.80 Crores due to bad investments by home trade. Chairman of Nagpur district Central Co-operative Bank was arrested for bending the rules to invest in government securities and preparing false documents

Conclusion

Financial frauds have become a complicated business and resorted to accounting frauds. After reviewing articles from different sources it can be said that creative accounting has emerged as a serious problem in showing true and fair picture of a company's financial position which is perceived to be the major objective of a company. In lieu of achieving desired return, making financial projections and reaping profits, professional seek loopholes in financial reporting standards which can be used to exploit. Companies use manipulative techniques, deceit and misrepresentation of accounts to reap higher profits, higher compensation, and increased market value of shares. Creative accounting exists because of several loopholes in the accounting standards and regulations. It is also realized that companies which have absence of powerful audit committees with weak internal control systems (Jensen and Meckling, 1976) or where majority shareholding is concentrated in few hands and have family relationships among directors and officers of the company tend to indulge more, in such activities as compared to firms where such an environment does not exist (Claessens *et al*., 2000). Greater promoter interest in companies may reduce the incentive for the controlling promoters to engage in practices that could jeopardize the long-term interests of their company. The accuracy and reliability of the financial statements are crucial for the stakeholders of the firms in order to make appropriate decisions (Susmus, 2013) According to Companies Act 2013, in India, the act regulates the companies, provides for the books to be kept, format of financial statements, accounting standards to be followed, procedures to be followed, scope of audit, power & duties of auditor and penal provisions of not following the rules. Accordingly auditors should be promoted to play active role in identifying and reporting manipulated estimates. Stringent measures should be undertaken to ensure regulatory compliance and the companies which do not follow corporate governance practices should be penalized. Corporate Governance can improve the quality of financial statements by taking help of independent auditors. There must be speedy disposal of disputes, investigation, and prosecution and adjudication process. For fraud detection and prevention forensic accounting should be employed. With such methods and suggestions it can be said that total elimination of creative accounting is not possible because of creativity of accountants and managers the impact of creative accounting can be reduced to some extent. Hence would lead to better corporate governance.

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