CREATIVE ACCOUNTING- OFFENCE OR DEFENCE (A CASE STUDY)

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Misstatement in the financial statements without violating the rules is Creative Accounting. Creative Accounting is the misuse of knowledge and skills in preparing accounts. Creative Accounting is portrayed as dishonesty, illegal, unethical and deceiving approach. With the use of creative accounting it can simply be asserted that company's financial accounts are not providing true and fair view. Various terms are synonymous to the concept of creative accounting. It is also called as earning management, financial engineering, cosmetic accounting, window dressing, earning smoothening etc. Sometimes it is also termed as aggressive accounting. In most of the cases profits are manipulated by using accounting skills. Profits are inflated to attract prospective investors and to win their confidence. It is unethical but it may not be illegal. It is very difficult to draw a line on ethical issues related to creative accounting In this paper nature, reasons and techniques of creative accounting is discussed.

Key words : Earning Management, Manipulation, Ethics, Earning Smoothening

INTRODUCTION

Creative accounting is a term which is mainly used when misappropriation in financial accounts is done to misguide the stakeholders. Manipulation done purposely has a direct impact on the apparent performance and the financial health of the organisation. While practicing creative accounting rules of accounting may or may not be followed. It is a systemic misrepresentation of the true and fair view of the financial statements. Inference of the use of creative accounting is that financial statements are not giving true & fair view about the financial health of the company. It is manipulation of accounting knowledge in such a way that instead of showing true pictures they are showing actually they want to show to the concerned users. Creative accounting is not a fraud but it takes

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the benefits of loopholes in the accounting standards and regulations. Creative accounting is the exploitation of loopholes in financial regulation in order to gain advantage or present figures in a misleadingly favorable light. (*Fareed 2015)* It cannot be said fraud because it works within the framework of law. (Yadav, Brijesh 2013)

DEFINITIONS OF CREATIVE ACCOUNTING

Creative accounting can be defined as 'an assembly of techniques, options and freedom room left by accounting regulation, without moving away from laws or accounting requirements, allowing to the managers to change the financial result or the financial statements' face'. (Gillet, Quoted By Shabou And Boulila Taktak, 2002).

In other words creative accounting is 'an assembly of procedures in order to change the profit, by increasing or decreasing, or to misrepresent the financial statements, or both of them' (stolowy2000).

"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" [Kamal Naser, 1992]

REVIEW OF LITERATURE

Michael Jameson (1988): "The process of accounting consists of many issues related to justice and conflict resolution between the presentations of financial results to financial transactions. This flexibility provides the opportunity for fraud, deceit and misrepresentation. These activities practiced by unscrupulous people of accounting are known as creative accounting."

Terry Smith (1992) – defined and gave his opinion from investor's perspective that most significant increases in profits, which occurred in 80 years were as a result of deceptive accounting group than genuine economic growth. Techniques involved, in the manipulation of accounts have been done without violating the accounting rules.

Hussey & Ong (1996) narrated that creative accounting prominently used in1980. Flexibility provided in accounting concepts acted as a loophole where, companies could produce accounts which flattered their financial performance. Various methods of depreciation, stock valuation, amortisations of fictitious assets are some areas where misrepresentation and manipulation in accounting can be done.

Amat, Blake and Dowds (1999) "Creative accounting offers a formidable challenge to the accounting profession. The problem is an international one, with accounting policy choice being a particular problem in the Anglo- American tradition and transaction manipulation a particular problem in the continental European tradition".

Shah& Butt(2011) Considered creative accounting more as a weapon. According to them if it does not go in wrong hands and misused it can be of great benefit to the user.

OBJECTIVES OF THE STUDY

1) To understand the meaning of creative accounting.
2) To study the reasons of creative accounting
3) To illustrate with case studies

WHY CREATIVE ACCOUNTING?

Creative accounting is not a new term used in the accounting world. This phenomenon is used due to various reasons. Out of various some can be enlisted as

1) GAAP allow companies to use different methods of accounting, where accountants are free to take subjective decisions. Certain entries in accounting involves unavoidable degree of estimation, judgment and prediction, artificial transactions can be used to manipulate balance sheet. Genuine transactions can be timed to give desired impression in the accounts.
2) Prospective shareholders and creditors generally take their decisions on the profits shown by the company in their annual reports. So whenever company needs investments from these it shows the profits according to the expectations of the parties.
3) Sometimes companies go in to a bad financial situation, to avoid in fall in price of their shares; accounts are manipulated without violating the rules.
4) "To Be the Best" is the continuous pressure which encourages manipulation in the accounts.
5) Continuous rise in high profits may be evaded to avoid raising expectations of the shareholders may lead to use the creative accounting

6) If it is expected that company is going to face losses in some years, instead of showing losses in more years all the expenses are amortized in one year so that more bad years can be converted in to one bad year.

7) Personal incentives like job security, promotions, self satisfaction, achievement of targets and bonus based on profits encourages accountants to show higher profits by abusing their knowledge.

8) Tax management is also one of the integral parts of creative accounting.

9) To lower down the remunerations based on profits, manipulations are done. One example is US film industry which claims huge expenses against successful movies to lower the remuneration of writers, producers, and actors (Grover 199 la).

10) Income smoothening is another reason to use creative accounting, where accounts are manipulated in such a way to give an impression of stability and continuous improvement.

Technical Flaws That Give Birth to the Idea of Creative Accounting

Six main areas are considered the "**source of inspiration**" for the creative accounting: flexibility in regulation, a lack of regulation, a scope for management that assumed some targets for the future, the timing of some transactions, the use of artificial transactions, but also the reclassification and presentation of financials. It was proved, that even in highly regulated countries such as USA the accounting environment afford, a great deal of flexibility (Largay, 2002; Mulford and Comiskey, 2002).

1. Generally the regulation, particularly the accounting regulation permits flexibility in choosing a policy to follow; the International Accounting Standards let the financial management to choose between valuation of the non-current assets at depreciated historical value or at revaluated value. The management may decide the change of the policies, and these shifts are difficult to be identified a few years later (Schipper, 1989).

2. Lack of regulation is meeting in some areas in every domain. In most countries accounting regulation is limited in some areas, for example in Romania there is few mandatory requirements for transactions with futures and stock options or for the recognition and measurement of pension liabilities.

3. Management can use their discretionary position in order to obtain the financial position and stability they assumed; for example, the managers decide the increase

or reduce of the provisions for bad debts (McNichols and Wilson 1988).

4. The timing of some transactions offers to the management the opportunity to increase the revenues, when the operating profit is not satisfactory, and to create the desired impression in the accounts. The existing stocks in company's patrimony, that have a significant higher value compared to the historical value, may be sold only when the operating profit is not satisfactory
5. The artificial transactions are often used in order to manipulate the balance sheet amounts or to move the profits between accounting periods. These transactions are realized by entering in a controlled transaction with two or more than two parties, one of them, most of the times, a bank. Such arrangements consists in selling of an asset at a higher/lower rate than in an uncontrolled transaction, and then leasing it back for the rest of it useful period, compensating through the rentals the price difference.
6. Reclassification and presentation of financials are relatively less analysed in accounting literature. However, in reality the companies often proceed to make up the amounts in order to obtain good level of profitability, liquidity or leverage ratios. Most of the times, the numbers are smoothly modified in order to improve the investors' perception. (Niskanen and Keloharju, 2000)

LABELS OF CREATIVE ACCOUNTING--- Creative accounting is also named as financial engineering, cosmetic accounting, cooking of books, earning management, innovative accounting, window dressing etc.

Aggressive Accounting	A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with GAAP or no
Earnings management	The active manipulation of earnings toward a predetermined target, which may be set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream
Income Smoothing	A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and "store" profits during good years for use during slower years

Fraudulent financial reporting	Intentional misstatements or omissions of amounts or disclosures in financial statements, done to deceive financial statement users, that are determined to be fraudulent by an administrative, civil, or criminal proceeding
Creative accounting practices	Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earnings management or income smoothing

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

CREATIVE ACCOUNTING AS DEFENCE

Creative Accounting is legal or illegal, ethical or unethical is an issue still on debate. But there is not any hard and fast rule to draw a line of demarcation between ethical and unethical prospects of creative accounting. Creative accounting is considered as this is a tool to deceive the users of financial information. But at the same time it can be used as weapon to save the company from crisis. An episode from Pakistan's cement industry is an example of creative accounting with no harm to any of the stakeholder. In mid-nineties, the country suffered an acute shortage of cement. The government announced a number of incentives for new cement plants and as a result a number of new plants were planned – seven to be precise. The combined production of these and existing plants was expected to meet the demands of cement for the country as well as leave a surplus for export to its neighbours like Afghanistan and India who are always short of this product. It takes three years for a cement plant to start production. By the time the new plants came into production in late nineties, the country's economic scenario had changed. The government had no money for development, the economy was generally in recession, and construction had virtually come to a halt. With tremendous overcapacity, the cement prices started falling precariously. The companies got together and slashed production. Plants started operating at an average of round 22% production capacity to ensure that prices do not fall. The prices drop stopped but still it did not help much. Now cement is one industry where the largest slice of costs is fixed and time related, rather than operations related. As much as 72% of annual costs of a new cement plant may comprise of only two items namely depreciation and interest. Both of these are fixed and computed on the basis of time. As a result, low capacity utilization meant higher cost per ton of cement produced in any period, leading to huge losses. One creative way found around this situation was to convert the depreciation cost from a fixed time related cost to a variable charge. To achieve this end, the method of computing annual depreciation by dividing the total plant cost over the number of plant's useful life was abandoned. Instead, the total cost of plant was divided over the total cement production to be expected from the plant over its entire life – thereby computing depreciation cost per ton of cement produced. This drastically curtailed the periodic charge to the Income Statement and improved the profitability figures. This had no implication for corporation taxes as depreciation is not a tax allowable expense virtually anywhere in the world. So using a creative accounting tool, the companies were able to show profits, or minimize losses, during a difficult period when the capacity utilization was low. This enabled them to keep the investors reasonably comforted and the staff relaxed. The interesting thing is that when the demand rose and companies started operating at higher capacity, they did not need to change their accounting policy. Hence, without any deception, ill-will or dishonesty, the directors of cement plants were able to pull through a crisis. (Zulfiqar Ali Shah, Butt, and Tariq *2011*)

CREATIVE ACCOUNTING AS OEFENCE

There is a wide variety of motivations for managers to engage in creative accounting.

Facts of Satyam Scam

Satyam Computer Services Limited was a "rising-star" in the Indian "outsourced" IT-services industry. The company was formed in 1987 in Hyderabad (India) by Mr. Ramalinga Raju. The firm began with 20 employees and grew rapidly as a "global" business. It offered IT and business process outsourcing services spanning various sectors. Satyam was as an example of "India's growing success". Satyam won numerous awards for innovation, governance, and corporate accountability. On January 7, 2009, Mr. Raju disclosed in a letter to Satyam Computers Limited Board of Directors that "he had been manipulating the company's accounting numbers for years". Mr. Raju claimed that he overstated assets on Satyam's balance sheet by $1.47 billion. Nearly $1.04 billion in bank loans and cash that the company claimed to own was non-existent. Satyam also underreported liabilities on its balance sheet. Satyam overstated income nearly every quarter over the course of several years in order to meet analyst expectations. For example, the results announced on October 17, 2009 overstated quarterly revenues by 75 percent and profits by 97 percent. Mr. Raju and the company's global head of internal audit used a number of different techniques to perpetrate the fraud. "Using his personal computer, Mr. Raju created numerous bank statements to advance the fraud. Mr. Raju falsified the bank accounts to inflate the balance sheet with balances that did not exist. He inflated the income statement by claiming interest income from the fake bank accounts. Mr. Raju also revealed that he created 6000 fake salary accounts over the past few years and appropriated the money after the company deposited it. The company's global head of internal audit created fake customer identities and generated fake invoices against their names to inflate revenue. The global head of internal audit also forged board resolutions and illegally obtained loans for the company. It also appeared that the cash that the company raised through American Depository Receipts in the United States never made it to the balance sheets. Greed for money, power, competition, success and prestige compelled Mr. Raju to "ride the tiger", which led to violation of all duties imposed on them as fiduciaries—the duty of care, the duty of negligence, the duty of loyalty, the duty of disclosure towards the stakeholders. "The Satyam scandal is a classic case of negligence of fiduciary duties, total collapse of ethical standards, and a lack of corporate social responsibility. It is human greed and desire that led to fraud. The fraud took place to divert company funds into real-estate investment, keep high earnings per share, raise executive compensation, and make huge profits by selling stake at inflated price. The gap in the balance sheet had arisen purely on account of inflated profits over a period that lasted several years starting in April 1999. "What accounted as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. This gap reached unmanageable proportions as company operations grew significantly", Raju explained in his letter to the board and shareholders. He went on to explain, "Every attempt to eliminate the gap failed, and the aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with real ones. But the investors thought it was a brazen attempt to siphon cash out of Satyam, in which the Raju family held a small stake, into firms the family held tightly". Following **Table 1** depicts some parts of the Satyam's fabricated 'Balance Sheet and Income Statement' and shows the "difference" between "actual" and "reported" finances.

TABLE 1

(Rupees in crores)

ITEMS	ACTUAL	REPORTED	DIFFERENCE
CASH AND BANK BALANCE	32	5361	504
ACCRUED INTEREST	NIL	376.5	37
UNDERSTATED	1230	NONE	123
OVERSTATED	2161	2651	49
TOTAL	NIL	NIL	713
REVENUES	2112	2700	58
OPERATING	6	64	58

Source: Bhasin et. al 2013

Fortunately, the Satyam deal with Matyas was "salvageable". It could have been saved only if "the deal had been allowed to go through, as Satyam would have been able to use Maytas' assets to shore up its own books". Raju, who showed "artificial" cash on his books, had planned to use this "non-existent" cash to acquire the two Maytas companies. As part of their "tunneling" strategy, the Satyam promoters had substantially reduced their holdings in company from 25.6% in March 2001 to 8.74% in March 2008. Furthermore, as the promoters held a very small percentage of equity (mere 2.18%) on December 2008, the concern was that poor performance would result in a takeover bid, thereby exposing the gap. It was like "riding a tiger, not knowing how to get off without being eaten". The aborted Maytas acquisition deal was the final, desperate effort to cover up the accounting fraud by bringing some real assets into the business. When that failed, Raju confessed the fraud. Given the stake the Raju held in Matyas, pursuing the deal would not have been terribly difficult from the perspective of the Raju family. **(Bhasin2013)**

The scandal broke in 2009 when founder-chairman of Satyam Computers Ramalinga Raju confessed that the company's accounts were tampered with. He disclosed a Rs.7,000-crore accounting fraud in the balance sheets. The 10 people found guilty in the case are: B. Ramalinga Raju; his brother and Satyam's former managing ddirector B. Rama Raju; former chief financial officer Vadlamani Srinivas; former pwc auditors Subramani Gopalakrishnan and T Srinivas; Raju's another brother B Suryanarayana Raju; former employees G. Ramakrishna, D. Venkatpathi Raju and Ch Srisailam; and Satyam's former internal chief auditor V.S. Prabhakar Gupta . In January 2007 Ramalinga Raju dropped a letter-bomb on unsuspecting investors, employees and the government confessing to a Rs.7136-crore fraud committed by him and his close circle of relatives and employees at the company. Citibank freezes Satyam's 30 accounts. Ramalinga Raju and his younger brother B. Rama Raju was arrested. Central govt disbands Satyam's board, to appoint its own 10 directors and Satyam was removed from Sensex & Nifty. In February 2009, CBI takes over investigation, goes on to file three charge sheets. Raju claimed that charges levelled by CBI are false. On November 2, 2011: Supreme Court grants bail to Raju since CBI failed to file chargesheet on time. October 28, 2013: Enforcement Directorate files a criminal complaint against 47 persons and 166 corporate entities headed by Ramalinga Raju. April 9, 2015: All 10 accused found guilty. A special court under Central Bureau of Investigation on April 10,2015 held that the former officials of Satyam Computer Services, guilty in accounting scam worth Rs. 7,000 Crores ($1.1 billion). B. Ramalinga Raju, the company's former chairman, has been sentenced to seven years in jail. (The Hindu, April 2015)

TO SUM UP

To conclude creative accounting is not exactly illegal, but on the other hand, it is not exactly widely promoted. Creative accounting is widely perceived as ethically undesirable, but has been defended on the grounds that sometimes it is desirable to misrepresent the financial figures to maintain the market share of the organisation without harming any of the stakeholders. Creative accounting to deceive is a curse. In ethical terms transformation of information, although within legitimate framework is not considered good, especially when the purpose is to deceive the stakeholders. It is unfortunately, not possible to eliminate creative accounting completely. Therefore, let us remember that the effect of creativity in accounting can be positive as it turns out to be. However, it must be accompanied by ethical and legal standards as well as international accounting standards. The subjective judgement and approach towards the use of accounting techniques is source of inspiration to misrepresent the information. it's important that accountants should not allow personal prejudice or bias to override the rules of standard accounting practices. It's not that creative accounting solutions are always wrong. Creativity is as much important in accounting profession, as it's in other professions provided that the intention is not bad while it leads to follow the rules accordingly. Accountants should find better ways to bring improvements to perform their tasks more efficiently and effectively by giving a boost to their creativity. It does not mean that creative accounting is always to make harm to the stakeholders, if it is used within the ramifications of the law and to achieve the short run goals of the company without making an offence against other users.

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