

## CREATIVE ACCOUNTING PRACTICES – ITS’ PROS & CONS: AN ANALYSIS

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### **ABSTRACT:**

*Financial statements/reports are the windows that depict the true and fair picture of the affairs of an enterprise. These are one of the most important ways for most business to reveal their performance and status to its stakeholders such as creditors, investors, regulators and employees. As an important means of representing the internal information to the public, the making of the statements is also desired to fulfill all the principles, regulations, standards, etc. and ideally should reflect a company’s wealth and activity performance through a transparent accounting system, therefore become the right tool to a fair and true company evaluation. Corporate governance can play an important role in financial reporting of the company because financial report shows the state of affairs of the company and investors take decision on the basis of financial report of the company. So it is necessary that financial report should show “True and Fair view’ of the company. But now-a-days, in order to create hype in the market, the companies are practicing some window-dressing practices. They are adopting some malpractices such as Creative Accounting. On this backdrop, the present study has been undertaken to analyze the impact of Creative Accounting Practices on the performance of a company in particular and stakeholders in general.*

### **Keywords:**

Creative Accounting, Financial Statements, Stakeholders, Malpractices

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## 1. CONCEPTUAL FALLACY:

Accounting is referred to as the language of business just as finance is branded the life blood of any organization. As a language of business, it is a process by which data relating to economic activities of an organization are classified, summarized, recorded and communicated to intended users for analysis and interpretation. The American Institute of Certified Public Accountants defined “accounting as the art of recording, classifying and summarizing in terms of money, transactions and events which are in part at least, of financial character, and interpreting the result thereof”. Millichamp (1997) defines “accounting as the process of identifying, measuring and communicating economic information to permit judgments and decisions by users of the information.” To satisfy this important role requires that the practice of accounting be done in uniform language and style. But in order to provide beautiful accounting information, many companies are adopting window-dressing accounting concept.

Economic development, legal and social pressure and users of information has necessitated innovations in accounts and as a result Creative Accounting has been developed especially in Anglo-Saxon economies due to the accounting profession freedoms. It sat on the edge of the legal form and economic substance of transactions and events. Accounting practices that follow required laws and regulations, but deviate from what those standards intend to accomplish. Creative accounting capitalizes on loopholes in the accounting standards to falsely portray a better image of the company. Although creative accounting practices are legal, the loopholes they exploit are often reformed to prevent such behaviors.

A primary benefit of accounting/financial statements is that they allow investors to compare the financial health of competing companies. However, when firms indulge in creative accounting often distort the value of financial information. Creative accounting can be used to manage earnings and to keep debt off the balance sheet. It is a practice whereby a company takes advantage of loopholes to show that they are more profitable or financially stable than they actually are. In many cases of creative accounting, the company is not yet breaking the law, but is most likely engaging in unethical behavior, which can lead to suspicion, audits by the government, and, in the case of fraud, finally the dissolution of a company.

While the problem of creative accounting is not new, it was one of the key themes in corporate finance and corporate governance in the 1980s. By the early 1990s, creative accounting was well and truly recognized by national and international regulators as one of their major headaches.

The excesses of creative accounting had been widely reported. The challenge of creative accounting goes to the heart of business regulation, business ethics and other fields.

In the accounting aspect, “window dressing” is more likely than “Creative Accounting” to imply illegal or fraudulent practices. The techniques of creative accounting change over time due to changes in accounting standards and techniques. Many changes in accounting standards are meant to block particular ways of manipulating accounts, which means that intent on creative accounting need to find new ways of doing things. At the same time, other, well intentioned, changes in accounting standards open up new opportunities for creative accounting. Many (but not all) creative accounting techniques change the main figures in the financial statements, but make themselves evident elsewhere, most often in the notes to the accounts. The market has been surprised before by bad news hidden in the notes, so a diligent approach can give an edge.

## 2. REVIEW OF LITERATURE

The investigation of the literature review initially concerns about the definition, motivations, existence and effect and the involved accounting standards of creative accounting.

Conner (1986) views that creative accounting refers to fraudulent reporting as it creates an illusion that the entity is healthier and more prosperous than it actually is. Amat, Blake and Dowds (1999) views that creative accounting as a process whereby accountants, capitalize on their understanding of accounting rules to manipulate the reported figures in books of account of a business. Naser (1993) opines it as the transformation of financial accounting figures to the desire of the preparers from what they actually are by taking advantage of the existing rules and or ignoring some or all of them. In the view of Gowthorpe and Amat (2005), creative accounting is the deliberate distortion of the communication between entities and shareholders by the activities of financial statement preparers who wish to change the content of the message being transmitted. Sen and Inanga (2005) says that creative accounting, also called deceptive accounting, is the application of accepted accounting techniques which permit corporations to report financial results that may not accurately reflect the substance of business activities. Copeland (1968) regards creative accounting involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, culminating in the reporting of stream of income with a smaller variation from trend than would otherwise have appeared.

Creative accounting, also called earnings management, aggressive accounting, according to Wikipedia (2008) is the manipulation of financial numbers, usually within the letter of the rules of law and standard accounting practices, but deviating from the spirit of those rules and certainly not providing the true and fair view that accounts are supposed to. Mulford and Comiskey (2002) identified creative accounting practices to include: recognizing premature or fictitious revenue, aggressive capitalization and extended amortization policies, misreported assets and liabilities, getting creative with income statement and problems with cash flow reporting. They added that managers play this game for rewards as favourable effect on share prices, lower corporate borrowing costs due to an improved credit rating, incentive compensation plans for officers and key employees and or political gains. Beside these, Merchant (1990) notes that general economic conditions are also an attracting factor for creative presentation of results. Hussey & Ong (1996) stated that creative accounting first became very prevalent in the 1980. Due to loopholes of accounting regulations, companies could produce accounts which flattered their financial performance. It talks about type of creative accounting like capitalizing interest, brand accounting, methods of depreciation, stock valuation, and accounting standards which prevent the major abuses which used to occur and has issued a number of regulations in the form of Financial Reporting Standards.

Naser (1992) stated that much is written about Creative accounting and about the various schemes of window dressing and off-balance sheet financing and very little information is available how widely such schemes are used by various companies. He has done a little empirical study to find the relationship whether creative accounting is related to the types of companies or industrial classifications, the reason behind the use of creative accounting, perceived legitimacy, consequences of the continued use of creative accounting, and measures to be taken to minimize its use. Because of much concern topic about creative accounting, it was difficult to obtain data from companies about their own creative accounting practices. However, it was felt by researchers that external auditors ought to represent an alternative source of creative accounting providing that their client information will keep secret.

Uşurelu, Marin, Danailă & Loghin (2010) explained that the ethics in accounting and creativity. They stated that ethics should be followed by an accountant and creative accounting is big challenge for them. Blake & Salas (1996) explained that creative accounting is seen as widespread in the U.K. and undermines the credibility as a disease. Mاتیş et al., (2012) described

creative disclosure as a feature of creative accounting. It is also known as impression management in literature. It can be found in corporate annual report under forms of distortion of narratives of numerical and graph manipulation. They gave importance to theoretical framework than empirical study because interpretation of empirical analysis is impossible without theoretical guidance. Creative presentation must be regarded as a complex mechanism that includes motives for engaging in manipulation of accounts, types of information disclosed and types of manipulation strictly connected to presentation of information.

### 3. OBJECTIVES AND METHODOLOGY:

Now-a-days due to Globalization, Liberalization and Privatization (LPG), many changes have occurred in the financial reporting practices. It has become mandatory for the corporate to disclose their affairs, both financial and non-financial for the welfare of the stakeholders. But to create hype, some firms are adopting malpractices in accounting, which ultimately affects the performance of the company. On this backdrop, present study “*CREATIVE ACCOUNTING PRACTICES - ITS' PROS & CONS: AN ANALYSIS*” has been undertaken with the specific objectives below:

- 1) To study the importance of Accounting and financial reporting
- 2) To analyze the causes for Accounting malpractices
- 3) To study the influencing factors of Creative Accounting
- 4) To study the meaning and various forms of Creative Accounting
- 5) To analyze the pros and cons of Creative Accounting
- 6) To analyze the impact of Creative accounting on the stakeholders in particular and the companies in general.

In order to accomplish the above objectives, secondary sources, available literature, reports and data have been used which has been obtained from various journals, reports, magazines and websites. The study is of qualitative in nature rather than quantitative

### 4. ANALYSIS:

Financial statements are one of the most important ways for most business to reveal their performance and status to investors, regulators and employees etc. As an important means of representing the internal information to the public, the making of the statements is also desired to fulfil all the principles, regulations, standards, etc. and ideally should reflect a company's wealth and activity performance through a transparent accounting system, therefore become the right tool to a fair and true company evaluation.



Although so many restrictions exist, there is still much space to bring into play, in order to appear a more attractive picture facing the public. The key to creative accounting's growing popularity is the increased international business, making the competition between firms fiercer, therefore, the temptation for them to ways around the rules at the time set in order to prettify the financial statements become more notable (Griffiths, L. 1987). The pressure on companies to report flattering results is greater than ever before. This necessity mothers the innovations in accounting creativity, which made it increasingly difficult for users of financial information to discern fact from fiction.

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. It is defined as "*Purposeful intervention in the external financial reporting process with the intent of obtaining some exclusive gain*". Due to the complexity of large financial accounts, creative accounting involves many trickery and at the same time, difficult to apply and detect. It offers a formidable challenge to the accounting profession.

Creative accounting, also called Aggressive Accounting, is the manipulation of financial numbers, usually within the matter 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. A typical aim of creative accounting will 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. Typical creative accounting tricks include off balance sheet financing, over-optimistic revenue recognition and the use of exaggerated non-recurring items.

#### 4.1. Advantages:

The following are some of the advantages of creative accounting:

1. Avoiding a potentially sharp drop in share price
2. Presenting the best possible earnings picture so as to maximize the price at which the issue is sold
3. Causing earnings to remain between the minimum and maximum earnings level so as to maximize incentive compensation

4. Minimizing the political costs of size and/or industry membership by avoiding what might be considered excessive profit levels
5. Avoiding the potential adverse effects of a covenants violation (for example, an interest rate increase, a demand for security or immediate repayment)
6. Avoiding an improper market response to earnings being temporarily off trend
7. Reducing earnings volatility so that a valuation penalty, associated with a perceived higher level of risk, is not assessed
8. Taking large write-offs immediately upon the arrival of new management, relieving future results of the charges and permitting blame to be assigned to outgoing management
9. Reserving any overstated portion of the accruals in order to achieve earnings goals in later periods.

#### **4.2. Categories of Manipulative Behaviours:**

Accounting systems are societal constructs which mirrors issues of individual morality and fundamental moral values as truthfulness. Rule of law, justice, fairness and morality are elements that help define ethical issues in accounting. They found two categories of manipulative behaviour viz., *Macro Manipulation* and *Micro Manipulation*. Macro Manipulation is the lobbying of regulators to persuade them to produce regulation that is more favourable to the interest of preparers of accounts. They found this is in USA with respect to Goodwill accounting. Micro manipulation where accounting figures is doctored to produce a bias view at the entity level.

#### **4.3. Trends of Creative Accounting Practices:**

A primary benefit of public accounting statements is that they allow investors to compare the financial health of competing companies. However, when firms indulge in creative accounting often distort the value of the information that their financials provide. Creative accounting can be used to manage earnings and to keep debt off the Balance Sheet.

#### **Boosting the Balance Sheet:**

This is the usual practice of many firms that inflate the figures of balance Sheet in order to present superbly their financial worthiness to the interested parties such as investors, shareholders, creditors and lenders etc. Companies that manipulate their balance sheet are often seeking to increase their earnings power in future periods (or the current period) or create the

appearance of a strong financial condition. After all, financially-sound companies can more easily obtain lines of credit at low interest rates, as well as more easily issue debt financing or issue bonds on better terms. The companies boost their Balance Sheet in the following ways:

**1. Overvaluing Assets:**

- ❖ *Provision for Doubtful Accounts:* Accounts receivables play a key role in detecting premature or fabricated revenues, but they can also be used to inflate earnings on their own by way of the provision for doubtful accounts. The reserve for doubtful accounts will prove to be inadequate in the future if adversely modified, but accounts receivable will receive a temporary boost in the short term. Investors can detect when the reserves for doubtful debts are inadequate by comparing accounts receivable to net income and revenue. When the Balance Sheet item is growing at a faster pace than the income statement item, then investors may want to look into whether or not the provision for doubtful accounts is adequate by further investigating.
- ❖ *Inventory Manipulation:* Inventory represents the value of goods that were manufactured but not yet sold. When these goods are sold, the value is transferred over to the income statement as cost of goods sold. As a result, overstating inventory value will lead to an understated cost of goods sold, and therefore an artificially higher net income, assuming actual inventory and sales levels remain constant. Investors can detect overvalued inventory and any unusual variations in inventory turnover can be indicative of potential inventory accounting fraud.
- ❖ *Subsidiaries and Joint Ventures:* When public companies make large investments in a separate business or entity, they can either account for the investment under the consolidation method or the equity method depending on their ability to control the subsidiary. Unfortunately, this leaves the door open to companies that want to conceal and manipulate the true performance of their subsidiaries or joint ventures. Under the equity method, the investment is recorded at cost and is subsequently adjusted to reflect the share of net profit or loss and dividends received. While this is reported on the balance sheet and income statement, the method does limit the information available for investors. This leads an environment ripe for manipulation.



## 2. *Undervaluing Liabilities:*

- ❖ *Pension Obligations:* Pension obligations are ripe for manipulation by public companies, since the liabilities occur in the future and company-generated estimations need to be used to account for them. Companies can make aggressive estimations in order to improve both short-term earnings as well as to create the illusion of a stronger financial position. Companies can make themselves appear in a stronger financial position by changing a few assumptions to reduce the pension obligation. Because the pension benefit obligation is the present value of future payments earned by employees, these accounts can be effectively controlled via the discount rate. Increasing the discount rate can significantly reduce the pension obligation depending on the size of the obligation. Meanwhile, companies can also use pension accounting in order to manipulate short-term earnings by artificially changing the net benefit cost, or the expected return on pension plan assets, on the income statement. An increase in the expected return on plan assets will reduce the pension expense in the income statement and boost net income.
- ❖ *Contingent Liabilities:* Contingent liabilities are obligations that are dependent on future events to confirm the existence of an obligation, the amount owed, the payee or the date payable. For example, warranty obligations or anticipated litigation loss may be considered contingent liabilities. Companies can creatively account for these liabilities by underestimating their materiality. Companies that fail to record a contingent liability that is likely to be incurred and subject to reasonable estimation are understating their liabilities and overstating their net income or shareholders' equity. Investors can avoid these problems by carefully reading a company's footnotes, which contain information about these obligations.

Companies can manipulate their balance sheets in many different ways, ranging from inventory accounting to contingent liabilities. However, investors can detect these practices by simply reading the financial statements a little more closely.

### 4.4. **Consequences of Creative Accounting:**

Though there are some advantages enjoyed by the firms, but it may reflect the performance of the firm in long-run. The malpractices in accounting not only affect the economic policies, but also the social policies of the company. The following are some of the economic and social consequences of Creative accounting:

1. Creative Accounting enables wrong analysis and interpretation of financial statements which ultimately leads to wrong decision-making.
2. It creates unnecessary hype in the share market by an artificial raise in share price, which enables the investors to invest their savings in a fraud company.
3. Wrong investment does give any earnings/ return on investments to the shareholders.
4. It deceives the lenders and creditors by presenting wrong figures in the Balance Sheet, about their financial soundness. In such cases, recovery of loans may become difficult if the company become bankrupt.
5. It gives wrong picture to the stakeholders, even to the Government and Tax Authorities.
6. Malpractices in Accounting spoil the reputation and goodwill of the companies, if detected.
7. It is a crime in legal aspect for which the companies are accused for severe punishment such as imprisonment and surrender of assets etc.
8. The Government / Tax authorities cannot evaluate the financial position of the firm which may become a hurdle for the sources of income to them.

Companies think that Creative Accounting enables them control over the stock market. But it is not true. It is the benefit enjoyed for short-term only, but in long-run the company may lost its reputation and vanish from the market.

##### 5. CONCLUSIONS:

The effects of the financial crisis which emerged at international level are being felt even nowadays: bankruptcies, investor's risk aversion, low liquidity, tightening credit conditions, price volatility are just some expressions of the phenomenon entitled "crisis". In these circumstances one should pay attention to financial statements, persons involved in drafting them, as well as those who are in charge with providing them. The responsibility for drafting and presenting the financial statements represents the duty of the company's management team, so that solutions to improve the perception and the situation regarding the financial statements should be found at this level and consist of self-imposed improvements regarding accounting policies and methods that are to be applied within the current activity because as long as it will just trigger major incidents which demonstrate the fact that, in most cases, huge financial losses were the direct result of abusive creative accounting, it will not find followers to support flexibility in the accounting field and it will act so as to restrict it.

It is unreasonable and difficult to suggest to the management boards of all companies to waive immediately all creative accounting practices they have been using so far. No doubt that all the companies need to maintain some flexibility in their accounting activity. However, this flexibility must be tempered by a strong dose of realism, removing any temptation to exploit the arising opportunities. Moreover, these opportunities intend to encourage a more accurate presentation of results, and not to distort them.

Creative accounting practices will not disappear unless the causes which have given rise to them will disappear, too. Therefore, although driven by the intention to limit creative accounting, the accounting normalisers must take into account the circumstances that allow its expression under close supervision.

While detecting the manipulations, the auditors should act as representatives of the stakeholders and hence should be careful and vigilant in detecting them. They should act as watch dogs and protect the interests of the stakeholders by giving true and fair position of the companies. At the same time, it is the responsibility of the companies to disclose the fair figures in their reports. Hence the companies should fulfill Corporate Social Responsibility for which Corporate Governance is essential.

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