Creative Accounting : a Tool to Suit Whims of the Top Management

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Abstract

Creative accounting is all about making manipulations in accounts by taking advantage of flexibility in accounting system to reflect the desired financial position. It is a tool for fulfilling aspirations of the management. There may be many reasons behind adapting the technique of creative accounting viz. finance from banks, adjustment for abnormal profits, hiding losses, inflating share prices, achieving higher remuneration and increasing income or assets and decreasing expenses or liabilities by making artificial transactions or adjusting the timing of recording transactions or choosing among different alternative methods are some commonly employed methods of creative accounting.

This paper is an attempt to bring out actual implications of creative accounting and highlight reasons why management resorts to this method of accounting. It, then suggests a few common methods to present the financial statements in more transparent way. To prevent or discourage the tendency of creative accounting in India, many provisions have been made in the Company Act 2013. A brief summary of those provisions are presented in this paper.

At the end, it can be said that ethical behavior on the part of the management, auditors and accountants will ultimately result in the reduction of malpractices seen in creative accounting.

Keywords *: Creative accounting, transperant way, company act of 2013.*

Introduction

The main objective for adopting the practice of creative accounting is to project the company financially stronger or weaker than the actual position depending on the management's aspirations. In fact , financial statements of the company should show the true and fair view of its financial position. But sometimes manipulations are done in accounts books for attracting investors or hiding the actual situation from stakeholders. Such kind of accounting manipulations which is termed as creative/ aggressive/ cosmetic accounting is surely unethical but not necessarily always illegal. This is a method of taking advantage of loopholes in the standardized

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accounting system for reflecting a more profitable and stable financial position than the actual situation.

This kind of unethical practices can provide short-term benefits but in the long run it cannot save the company from its disasterous effects. Downfall of big companies such as Enron and Satyam are biggest examples of adverse impact of creative accounting. In spite of these instances, companies resort to the technique of creative accounting. Before analyzing the reasons behind adaption of techniques of creative accounting, its pratices should be clearly understood.

There are no single definition for the term creative accounting. Some authors argue that the creative accounting is 'an assembly of techniques, options and freedom found in the accounting regulation allowing managers to manipulate financial results and financial statements without moving away from laws or accounting requirements' *(Gillet, quoted by Shabou and Boulika Taktak, 2002)*.

People of different fields have different opinions on the concept of creative accounting. For example, ***Ian Griffiths***, a business journalist states that, "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. Figures which are fed twice a year to the investment in the company public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse. In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting."

Similarly, **Michael Jameson**, an accountant says that, "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 practiced by the less scrupulous elements of the accounting profession - have come to be known as creative accounting"

Kamal Naser defines the term from **academic** view and states that, "Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them."

The creative accounting is all about making manipulations but it is different from fraud as fraud is always illegal whereas creative accounting is unethical. Creative accounting is based upon using the flexibility within accounting to manage the measurement and presentation of accounts so that these serve the interests of preparers whereas fraud is stepping outside the regulatory framework deliberately to give a false picture of the accounts. There is a famous statement that "Power corrupts but absolute power corrupts absolutely." Thus the creative accounting has emerged as a deadly side–effect of resting the entire financial reporting in the hands of top management i.e. the board of directors, the accounting and finance teams. The creative accounting has been defined time and again and is also famous by the pseudo names of "cooking the books" or "enronomics".

Reasons Behind Creative Accounting

Schipper (1989) observes that 'creative accounting' can be equated with 'disclosure management' in the sense of a purposeful intervention in the financial reporting process. There may be different motives behind adapting the practice of creative accounting in a company. It may be adapted by managerial personnel for their own incentives such as increasing salaries through profit related pay, bonus schemes, share options, etc. It may also be adapted for profit smoothing to meet market expectation or it may be followed in some special circumstances, e.g. to manage gearing new issues, mergers and acquisitions, etc. Some of the main reasons can be identified as follows.

Obtaining Finance from banks

Since financial requirements of a company cannot be fulfilled from its own resources, they need financial assistance from banks. Before granting financial assistance, banks want to be assured of the solvency position of the company. Such assurance can be obtained from those financial statements which show stable financial position and reflects potential for future growth. Companies resort to the technique of creative accounting for making its financial statements reflecting more stability and solvency so that loans can be easily obtained from banks.

- **To Account for Abnormal Profits**

Manipulations are not always done for showing better position. Sometimes it can be done for showing weaker position than actual one. There are many such circumstances when a company does not want to reveal the actual amount of profit, especially when the company earns excessive or abnormal profits in a particular year. Tax evasion or avoiding future competitors who may be attracted to the same business due to excessive profit or avoiding excess bonus or salary demand from employees etc. can be reasons behind such type of decision.

- **To Inflate Share Prices**

Every company wants to attract investment while investors give preference to those share, prices of which are usually and consistently higher than those of other companies. Share prices are directly dependent upon EPS (earning per share) which is influenced by net profit. Thus, while high share prices and high profit all are interrelated with each other, companies needs funds for generating more profits. Hence, the practice of creative accounting is adapted for reflecting high profit in financial statements with the intention of inflating share prices thus attracting larger investment.

- **To Hide Losses**

Reputation of a company in the market is very important and the this is adversely affected if a company incurs losses in a particular year and ultimately results into demotivating investors. To avoid such kind of situation, manipulations are done in accounts to hide losses. Hiding losses or adjusting in succeeding years is the main reason behind adopting the practice of creative accounting.

- **To Obtain Higher Remuneration**

Many times creative accounting is used by the top management for their interests and not in the interests of the owner. In many companies, managerial remuneration depends upon net profit. Top officials get remuneration in the form of a certain percentage of net profit. Higher amount of remuneration is directly associated with higher amount of profit. For enhancing the amount of remuneration, the management makes manipulation in accounts to inflate the amount of profit.

Thus, creative accounting is adapted for benefits of different stakeholders; sometimes it is in the interest of shareholders and sometimes it is in the interest of top managerial personnel but one thing is certain that it is always against the convention of full disclosure.

Methods of Creative Accounting

According to ***Largay, Mulford and Comiskey,*** the potential for creative accounting is found in six principal areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgment with respect to assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers.

Creative accounting is all about making manipulations in accounts for reflecting the desired financial position. For this purpose, following methods are usually adopted:

- Changing depreciation on assets at a very high rate which is more than necessary
- Undervaluation of assets
- Overvaluation of liabilities
- Showing contingent liability as actual liability
- Treating capital expenditure as revenue expenditure
- Making provision for anticipated losses like bad and doubtful debts which is more than necessary
- Making provision for contingent liabilities which is more than necessary
- Not making adjustments for prepaid expenses
- Showing wrong liability
- Complete elimination of assets

All these steps result into creation of secret reserve which is banned under Companies Act but these techniques are followed by the management for hiding the actual situation. Overstatement of revenue, manipulation of expenses, overvaluation of assets, concealment of losses or liabilities, off balance-sheet finance, tampering taxation, acquisition of goodwill, capitalization of research and development expenditure, changing depreciation and inventory policy, etc. are some commonly used methods adapted in creative accounting for projecting situation to be better than actual position. All the methods of creative accounting can be broadly categorized into following classes:

- Choice among different methods
- Artificial transactions
- Timing of recording transactions

Role of Companies Act, 2013 in the Creative Accounting Practices

The creative accounting should not be encouraged in companies as it is totally unethical. Many provisions have been made in the Companies Act, 2013 for preventing practices of creative accounting in India. Some of the main provisions are as follows:

- Sec 2(40) of the Companies Act made cash flow statement a mandatory part of financial statements along with balance sheet and profit & loss account. ***Mandatory inclusion of cash flow statement*** will clarify the actual liquidity position before all stakeholders and it will be difficult to make manipulations in cash transactions.

- A popular method of creative accounting is making adjustment in revenue or expenses of holding and subsidiary companies by taking advantage of different financial year or accounting period. Such kind of manipulations is also done between the accounts of two years for reducing tax liability. But now, according to Sec 2 (41), the financial year of every company must end on 31st March every year which is the same period as is required for tax reporting purposes. Thus, compulsion of ***uniform financial year*** for every company will be helpful in checking the practice of creative accounting.

- In the Companies Act, 1956 the quorum requirement for convening meeting was not based on number of members of the company only presence of 5 members was required in the case of the public company for getting legitimacy for holding general meeting which provided enough scope for adoption of creative accounting practices with the connivance of small number of members present in the meeting. But in Companies Act, 2013, the **quorum requirement** has been **increased** depending upon the total number of members of the company. Hence, for taking such unethical decisions in a meeting, a large number of members have to be convinced which may be a difficult task if motivation is based on narrow interests.

- According to Sec 138 of Companies Act, 2013 such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit functions and activities of the company. Time intervals and manner of conducting internal audit shall be prescribed by the Central Government.

- **Compulsion of regular internal audit** by a professional auditor is a big step towards checking the practice of the creative accounting. Accountants may not be able to make manipulations in accounts unless there is collusion between accountant and internal auditor.

- Role of the auditor is most important in identifying and preventing practices of the creative accounting in a company. Long term implementation of such methods is not possible until the auditor is also involved with the accountant. To discourage such type of tendency, provisions regarding **rotation of auditors** and **time bound appointment** have been introduced in the new Companies Act.

- Sec 139 makes provision for a system of time bound annual appointment or reappointment of auditors by Controller and Auditor General of India (CAG) for government companies. Furthermore, listed companies and some prescribed classes of companies must implement compulsory rotation for auditors. They may not appoint auditors for (i) more than two consecutive five year terms if the auditor is from an audit firm; or (ii) for more than one term of five consecutive years if the auditor is an individual.

Changes in rules regarding appointment or reappointment of auditors were necessitated by disclosure of auditor's role in the famous Satyam Scam.

- Sec 149 of the Companies Act 2013 has increased the limit for maximum number of directors. It also provides for the appointment of **independent directors** and a minimum time limit of 182 days for at least one director to reside in India has also been prescribed. Such kind of clauses will ensure active participation of directors. It will not be easy for officers or accountants to deceive directors and adopt the techniques of creative accounting.

- Sec 211 of the Act provides for establishment of **Serious Fraud Investigation Office** by the Central Government to investigate frauds relating to a company. Besides that, Sec 447 provides for strict **punishment and fine** against persons committing frauds. Existence of such provisions will obviously act as a moral check upon accountants and management before adopting unethical techniques of creative accounting.

- According to Sec. 118, minutes of the proceedings of every meeting of any class of shareholders or creditors or board of directors or every committee of the board should be maintained by the Company. Besides that every resolution passed by postal ballot should also be mentioned in the minute book. These clauses will bring transparency to the working of a company and it will be difficult to make manipulations.

- Prior to the implementation of the Companies Act 2013, it was not compulsory for holding company to prepare consolidated financial statements. There was enough scope for accountants to make manipulations between accounts of holding and subsidiary companies. They could make adjustments in assets and liabilities and showed only favourable position. But now, **consolidated financial statements** are mandatory for companies having one or more subsidiaries or associates or joint ventures. Thus, it shall not be possible for accountants to make such kind of unethical adjustments.

- Sec 132 makes provision for constitution of **National Financial Reporting Authority** (NFRA) which has replaced the National Advisory Committee on Accounting Standards (NACAS) established under 1956 Act. NACAS was a mere advisory body under the 1956 Act but the 2013 Act renamed it as NFRA and has converted it into a body with quasi-judicial powers to discipline the Charted Accountants. It will create a sense of fear among auditors before indulging in an unethical collusion with the client to deceive stakeholders.

  On the basis of above mentioned provisions, it can be said that the new Companies Act is an attempt towards reducing creative accounting and other malpractices in financial statements in India.

Conclusion

Financial crisis in the recent past throws light on weaknesses in reporting systems of the financial statements. Creative Accounting has made the stakeholders worried about their investments and has significantly reduced their trust on financial reports, as time and again the reports have been distorted to present a favourable picture with the help of practices like the creative accounting. The creative accounting pratice through many methods such as increasing income by premature sales, recognition or decreasing expenses by capitalization of interest or increasing assets by enhancing goodwill and revaluing fixed assets or decreasing liabilities by off balance sheet financing and reclassifying debt as equity. Poor corporate governance, lack of proper external audit

Howsoever attractive it may appear, the creative accounting in the long run never succeeds in achieving its objectives as is evident from some sensational biggest collapses like HIH in Australia, Zhenzhou Baiwen in China, Paramalt in Italy, Enron in US and Satyam in India. When creative accounting comes into light, many adverse consequences have to be faced by the stakeholders. It may result into loss of share price, liquidation of company, takeover by another company, punishment to directors and fine to auditors. To prevent the practice of creative accounting, changes in laws, regulations, new codes of corporate governance and their continual revisions are required. New accounting rules and recently passed Companies Act hope to curb the unethical practices prevailing and enabling preparation of financial statements in a standardized form by reducing the element of choice in various accounting methods, assumptions and techniques. The ethical behavior of management, accountants, auditors and their understanding of long-term viability will eventually reduce the malpractices. As "WITH GREAT POWER COMES GREAT RESPONSIBILITY".

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