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Creative Accountingand Fraud : An Overview

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Abstract

Creative Accounting approach creates a new kind of accounting which is called in accounting practices creative. Manipulation that does not lie within the law and standards is considered to be fraud. Engaging in the practices of creative accounting or manipulation accounting is within the law and thus is not considered to be fraud.

The study wishes to propose that creative accounting if used correctly, can be of great benefit to the user but if it is mishandled or goes into the hands of the wrong person, it can cause much harm.

It is not possible to reduce the impact of creative accounting completely because of involvement of managers and auditors and slow work of regularities bodies.

Auditors should provide good information to all shareholders and check all the transactions for improving financial reporting quality and to increase the faith of investors in companies. Financial report, corporate governance should play big role wherein independent directors can be chosen by shareholders and true information should be provided to shareholders about the companies state of affairs so that it is easier for the investors to take investment decisions .

Keywords: Creative Accounting, Corporate Governance, Fraud, Financial Reporting

Introduction

Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character and interpreting the results thereof.(AICPA)

Creativity is the ability to transcend traditional ideas, rules, patterns, relationships, or the like and to create meaningful new ideas, forms, methods, interpretations etc.

Creative Accounting approach creates a new kind of accounting which is called in accounting practices creative.

It is creative mainly because their primary mission does not follow accountants or tax laws but mostly a “clever idea” of the owners or in other words “creative attitude” where the imagination plays a decisive role.

Accounting is the language of business and could be easily found but also when the rules are used in the right way they could be unprecedented. It is the shareholders and directors who are responsible for the accuracy of accounts. Creativity in accounting therefore comes at a time when the true background, figures and results reaches the public. When we talk of accounting, broadly the two types of accounting- management and financial accounting they cover both the information required by internal and external users.

Objectives of the study

The objective of the study is to find out how creative accounting may be done, what are the reasons for manipulation and to check whether creative accounting is fraud or not.

Review of Literature

Hussey & Ong (1996) stated that creative accounting was rampant in 1980s. Due to loopholes in accounting regulations companies could produce accounts which flattered their financial performance. Capitalizing interest, brand accounting, methods of depreciation, stock valuation and accounting standards were used. A number of regulations in the form of financial reporting standards were introduced as a result.

Rabin (2005) described auditor’s attitude and ethical behaviour towards creative accounting.

Cosmin (2010) described the various techniques used by managers to get desired results.Pradeep Sodhi (2008) considered financial management as perhaps the most important aspect of a corporate management. Financial Management is an inherent, indispensable part of management.

Matis et al (2009) explained the Romanian example, how cash is a king. Creative accounting impact profit and loss account and balance sheetut cannot impact on cash flow statement because it is a lot harderto manipulate. We can raise minimize value but we cannot make the money pop. The scope for creative accounting is restricted but not impossible. Romanian managers have looked deeply into cash flow hedging opportunities techniques.

Shah et al (2011) tried to answer why do managers resort to creative accounting and how do they become successful in performing such practices despite stringent rules and procedures.

Teodara & Nicolae (2009) explain the level to which financial accounting professional comply with the professional ethics standards. They found managers do not agree that innovation and creativity in financial accounting statement is fraud. Creativity and innovation is used by companies to get additional financial resources by capitalizing on legal ambiguities. Companies do not use creativity and innovation fear of and internal and financial auditors, stakeholders.

Research Methodology

The study is of descriptive nature. The information is collected from secondary sources.

Why Creative Accounting?

The typical aim of creative accounting will be to inflate profit figures. Companies generally prefer to report an increasing trend of growth in profit rather than to show volatile profits with a series of rise and fall. This was done by making unnecessarily high provisions for liabilities and against asset values in good years so that these provisions can be reduced thereby improving reported profits in bad years. Assets and liabilities may also be manipulated either to remain within limits such as debt covenants, or to hide problems. Tricks of creative accounting include off balance sheet financing, over optimistic revenue recognition and the use of exaggerated non-recurring items. It is also called aggressive accounting and most often comes from the very person who maintains the accounts.

Creative Accounting has saved many companies in crisis. This weapon is always innocent and the fault emerges because of the user. This can be expressed with the help of an example

ABC Co. produces cement. The country faces shortage of cement, the government announced a number of incentives for new cement plants. The combined production of these and the existing one were expected to meet the demand. Unfortunately the production started late and country's economy went into recession. As a result the cement prices started falling. 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, 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 profitability figures. This had no implication for corporation taxes as depreciation is not a tax allowable expense virtually anywhere in the world. Using a creative accounting tool, the companies were able to show profits or minimize losses during a

difficult period when capacity utilization was low. The interesting thing is that when the demand rose and the 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 were able to pull through crisis.

This is how creative accounting works. It may also be referred as "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."

Every company in the country manipulates its accounts. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing 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. The mangers are motivated for fixing financial statements for either managing position or profits.

They are concerned to meet external expectations, to provide income smoothing for change in management etc. Aggressive accounting is normally portrayed maligned and negative act. Whenever these words are mentioned the image that emerges in one's mind is that of manipulation, dishonesty and deception. Creative accounting is a tool which used correctly, can be of great benefit to the user. If mishandled or goes into wrong hands it is a dangerous weapon.

Creativity in accounting can be bad, that doesn't mean that it must be bad. If creative accounting adheres with ethical and legal standards as well as the Generally Accepted Accounting Principles (GAAP), they can yield immense benefits to the company and its stakeholders.

Creative Accounting Vs Fraud

Manipulation that does not lie within the law and standards is considered to be fraud. Engaging in the practices of creative accounting or manipulation accounting is within the law and thus is not considered to be fraud. If a company decides to falsify invoices so it can increase its sales figures is considered as fraud. On the other hand making a false estimation on bad debts is not considered to be fraud.

According to Belkaoui (1989) fraud is defined as "Falsifying or altering documents, deleting transactions from records, recording forged transactions or concealing significant information"

Creative Accounting deals with the misrepresentation of accounting figures, by following the standards set by the accounting conventions while fraud is falsification of accounting figures made by disobeying the law. Due to difficulty of the distinction between creative accounting and frauds, the commission for reporting fraudulent finance defined fraud as "Materially misleading financial statements" (NCFRR 1987)

Table-1
Generally Accepted Accounting Procedures

Particulars	Accounting Choices	Actual Choices
Conservative Accounting	Aggressive recognition of provisions or reserves. Over valuation of acquired in process R&D in purchase acquisition	Delay in sales Accelerating R&D or advertising expenditure
Aggressive Accounting	Understatement of the provision for bad-debts.	Postponing R&D or advertising Expenditure.

Fraudulent accounting takes place when GAAP is violated i.e. recording sales before they are realizable, recording fictitious sales, overstating inventory by recording fictitious items. Fraud occurs when it violates GAAP, other forms of manipulations within the accounting standards and thus are legitimate.

Accounting Scandals

They are political and/or business scandals that arise with the disclosure of financial misdeeds of trusted executives of corporations or governments. Such deeds typically involve complex methods for misusing or misleading funds, overstating revenues, and understating expenses, overstating the value of corporate assets or under reporting the existence of liabilities.

But it is seen at large that not all accounting scandals are caused by the top executives. often managers and employees are pressured or willingly alter financial statements for the personal benefit of the individuals over the company. Managerial opportunities play a large role in these scandals. For example managers who would be compensated more for short-term results would report inaccurate information, since short term benefits outweigh the long term benefits, such as pension obligations.

Enumerated below is a list of reported accounting scandals. As such this list is long but we will discuss a few:

Table -2
Prominent Accounting Scandals In Last Two Decades

Name of the Company	Year	Audit Firm	Country	Remarks
Phar-Mor	1992	Coopers & Lybrand	United States	Mail fraud, wire fraud, bank fraud and transportation of funds obtained by theft or fraud
Waste Management, Inc.	1999	Arthur Andersen	United States	Financial misstatements
Lernout & Hauspie	2000	KPMG	Belgium	Fictitious Transactions in Korea and improper accounting methodologies elsewhere
Xerox	2000	KPMG	United States	Falsifyingv financial results
Enron	2001	Arthur Anderson	United States	Used shortcomings of rule based US GAAP
AOL	2002	Ernst&Young	United States	Inflated sales
Bristol-Myres Squibb	2002	Price Waterhouse Cooper	United States	Inflated revenues
Sunbeam	2002	Arthur Andersen	United States	Overstated sales and revenues
Merck & Co.	2002	Price waterhouse Cooper	United States	Recorded co-payments that were not collected
Royal Ahold	2003	Deloitte & Touche	United States	Inflating promotional allowances
Chiquita Brands International	2004	Ernst & Young	United States	Illegal payments
AIG	2004	Price Waterhouse Coopers	United States	Accounting for structured financial deals
Satyam Computer Service	2009	Price Waterhouse Coopers	India	Falsified Accounts
Amir-Mansour Aria	2011	Iao(audit Organization) And otherAudit firms	Iran	Business loans without putting any collateral and financial system
Bank Saderat Iran	2011	Iao(audit Organization) And otherAudit firms	Iran	Financial transactions among banks and Getting lot of business Loans without putting any collateral.

[Source- en.wikipedia.org/wiki/Accounting_Scandals]

Enron was originally involved in transmitting and distributing electricity and natural gas throughout the United States. The company developed, built and operated power plants and pipelines while dealing with rules of law and other infrastructure worldwide. Enron traded in more than 30 different products. The Enron scandal was a corporate scandal involving the accounting, auditing and consultancy firm Arthur Andersen. The company used shortcomings of US

GAAP. Anderson was pressured by the company to ignore accounting practices.

Till 2001 Enron senior management used complex and foggy accounting schemes to reduce tax payments, income and profits, inflate stock price and credit rating, hide losses in of balance sheet subsidiaries. Thus fraudulently misrepresent Enron's financial condition in public reports. On Oct 16 2001 Enron Announced a huge third quarter loss of $ 618 million. On Oct 22 2001, the Securities and Exchange Commission (SEC) began an enquiry into Enron's accounting practices.

Then in December 2001 Enron filed for bankruptcy, thousands of employees lost their jobs and stock market fell down disastrously in financial services industry, as a result Arthur Anderson which at the time was one of the five largest accounting firms in the world was dissolved. In the aftermath, the regulators started seeking improvement in standards and practices in accounting, corporate governance, and pension fund administration to ensure that another Enron does not occur.

In 2003, Nortel made a contribution to the list of scandals by incorrectly reporting a one cent per share earnings directly after their massive lay off period. They used this money to pay the top 43 managers of the company. The SEC and the Ontario Securities Commission eventually settled civil action with Nortel.

In 2005, a scandal tainted insurance and mutual funds. AIG was investigated for accounting fraud. The company lost over 45 billion US dollars' worth of market capitalization because of the scandal. Investigations also discovered over a billion US dollars worth of errors in accounting transactions.

The Satyam Case **(**2009) was perhaps India's biggest corporate fraud case where M/S Satyam Computer Services Limited caused loss to the investors to the tune of Rs. 14,162 crore. The company's head Ramalinga Raju and members of his family secured illegal gains to the tune of about Rs. 2743 crores by various tricks. The fraud was done by inflating the revenue of the company through false sales invoices and showing corresponding gains by forging the bank statements with the connivance of the statutory and internal auditors of the company.

Creative Accounting Techniques

A few Creative Accounting Techniques are as follows-

1. Comparisons of accounting policies used in the current financial year as compared to the previous year.
2. Analyzing the existing of opinions with reserves in auditors' report.
3. Examining accounting registers.
4. Comparisons with accounting policies and methods used by competitors.
5. Analysis of movements in reserve accounts.

Reasons Behind the Manipulative Behaviour

For detecting the manipulation of financial accounting information it is important to review the reasons behind this manipulation. The contents of accounts manipulations implicate the ways accounting is used to alter financial reports in order to modify users' perception of firm's performance. The data in financial reports can be manipulated in any of the three ways.

1. By use of pure accounting choice (misusing alternative accounting choices and estimates).
2. By classifying and disclosing items.
3. By structuring and timing real transactions in order to achieve reporting goals.

First and the third case can be defined as inter-period accounts manipulation, while the second case is intra-period accounts manipulation. Accounts manipulation is defined as the use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transaction between the firm, society (political costs), fund providers (cost of capital) or managers (compensation plans).

In the first two cases, the firm gets benefits from the wealth transfer and in the third case the managers act against the firm. Manipulating financial information is not only costly task but is risky also. Firms need to be very careful when engaging in manipulative behaviour. Creative Accounting is practiced in order to create interest amongst different groups i.e. in society, firms etc. The main reason of the practice of Creative Accounting is to change the reported earnings by increasing or decreasing it as per the company's situation.

The following can be the main reasons of using Creative Accounting

1. To obtain additional financing from banks.
2. To report unrealistic profit.
3. To inflate share prices
4. To hide losses
5. To attract customers by showing a better and more successful image.
6. To achieve performance related bonus
7. To cover up theft

Ethical Issues

Ethics in accounting refers to the morals and judgments that a professional needs to follow while inculcating rules and regulations in accounting. The conduct or ethics oblige the accounting professionals to have a high degree of self-discipline. Ethics, if followed straightens the confidence of the public towards private firm. There exist a set of guidelines made by AICPA that should be used in the field of public accounts. In order to prevent the manipulative behaviour , firms should obey to the codes of ethics that will prevent them from being dishonest. Any firm that fails to obey should be punished by either imposing heavy fines or by forbidding the firm to continue its working, then only firms will no longer falsify their books.

Conclusion

Creative accounting is the biggest problem in financial reporting by the companies which are affected by different incentives perceived by the different interest groups in the company like managers want to show higher profit to increase their compensation, to increase market price of the share of the company and show low profit so that they can deny the demand of increase in salaries and incentives of the worker and have to pay low taxes to the government. Creative Accounting is not a fraud but it takes the benefits of loopholes in the accounting standards and regulations, under the framework of law. It takes advantage of multiple options available in accounting standards to show the transactions like different methods of depreciation and estimating useful life of asset and applying different methods in valuations of inventory. It is not possible to reduce the impact of creative accounting completely because of involvement of managers and auditors and slow work of regularities bodies.

Recommendations

In India creative and fraudulent accounting can be reduced by streamlining the accounting and auditing system and applying effective corporate governance, manager should take responsibility of bad position of the company. They should provide quality and competent service to their customers. A Law should be made which can reduce the chances of alternate accounting methods. Companies act should be amended, forensic accounting for white collar fraud should be introduced. Auditors should provide good information to all shareholders and check all the transactions for improving financial reporting quality and to increase the faith of investors in companies financial report corporate governance should play big role wherein independent directors can be chosen by shareholders and true information should be provided to shareholders about the companies state of affairs so that it is easier for the investors to take investment decisions.

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