Ethical Issues Concerning Creative Accounting

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Abstract:
This article deals with ethical issues concerning Creative Accounting. Creative accounting is the practice which is adopted within the framework of accounting system or in other words taking undue advantage of loopholes of accounting system is creative accounting. However the recent major accounting scandal in India i.e. Satyam Computers was a fraudulent accounting practice. In highly competitive market, it becomes very important and necessary for every business to find new and innovative ways of running the business. And one of the new ways is creative accounting. Creative accounting is an art of manipulating the books of accounts in a manner that desired results can be drawn. Aggressive accounting, cooking the books and massaging the numbers are few common terms used in context of creative accounting. Creative accounting in present uncertain environment is facilitating management to accomplish personal goals as big, well established firms followed.

Traditional accounting was limited to recording, classifying and summarizing the monetary results and communicating the same to investors. But modern accounting demands higher level of transparency with accurate reporting of financial position of the firm. The change has been seen in modern accounting system after a change in financial market. Companies are also taking active part in obtaining funds through market. As the contribution of public funds increased in the corporate sector, the demand of transparency also increased and thus the way of managing books has also changed. Companies are trying to find out methods whereby they can provide full transparency & simultaneously accomplish their personal goals.

Keywords: Accounting ethics, creative accounting, earnings management, GAAP, financial reporting.

Introduction:
Subject of Creative Accounting is normally portrayed maligned and negative act. As soon as these words “Creative Accounting” are mentioned, the image that emerges in one’s mind is that of manipulation, dishonesty and deception. According to agency theory ‘the firm is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.’ Within the agency framework, it is both logical and inescapable that management behaviour will be self-serving. Agency can, therefore, provide a solid framework for the understanding of creative accounting behaviour. However, it may provide an incomplete theoretical basis for explaining or predicting management behaviour; the ethical dimension of human behaviour may provide an important element missing from legalistic and adversarial agency relationships.

The informational perspective is a key element underpinning the study of the creative accounting phenomenon. A conflict is created by the information asymmetry that exists in complex corporate structures between a privileged management and a more remote body of stakeholders. Managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosures in their own favour. The informational perspective assumes that accounting disclosures have an information
content that possesses value to stakeholders in providing useful signals.

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Definitions of Creative Accounting:

Creative accounting is referred to also as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting. The preferred term in the USA, and consequently in most of the literature on the subject is ‘earnings management’, but in Europe the preferred term is ‘creative accounting’ and so this is the term that will be used in this paper. It should be recognised that some accounting manipulation involves primarily balance sheet rather than earnings management. Definitions of creative accounting vary, and include the following:

“Purposeful intervention in the external financial reporting process with the intent of obtaining some exclusive gain”.

“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, 1993:2)

“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. 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.” (Ian Griffiths, 1986:1)

This paper considers that how creative accounting involves a transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulation.

Presence of Creative Accounting In India:

According to Nobel Research Report – 50 Good market cap size companies are indulged in creative accounting practices and investors have to carefully examine the books of accounts, its profits and cash flows. After the news of Satyam, question is raised on all the giant firms which were directly or indirectly related with company. India is developing economy where corporate sector is contributing a major part in national income, and it is spreading its wings all over world where they get lots of opportunities to go for creative accounting as all countries have different accounting system which creates ambiguity in
investor’s mind. And thus number of accounting scandals is increasing in India.

Creative accounting is prevailing in almost all the companies in India, the reason might be the increasing level of competition and dearth of sustain in the market. Loopholes or weaknesses in Indian accounting standards are facilitating the corporate sector to indulge in creative accounting practices. They find that where the relevant accounting standards are permissive managers will exploit the potential use of creative accounting. Such behaviors are curtailed once the provisions of accounting standards are tightened. But the loopholes are so common and prevailing in accounting standards in such a manner that even if certain loopholes are eliminated, the practice of creative accounting is likely to exist. Nobel research report highlighted the common manipulations in accounting records in India:

1. Revenue manipulation: a) Recording revenues ahead of time; b) Booking fictitious sales:
2. Expense manipulation
3. Cash manipulation
4. Invisible restatement of prior period accounts Most of the companies in India are taking undue advantage of weaknesses of accounting principles. Like as mentioned by Nobel Research report companies tend to show revenue which is not earned. This is also considered as aggressive accounting technique whereby revenue is shown in the books of accounts before the project is completed in effect of which revenue increases. Cash manipulation is one of the common practices followed by most of the companies.

Motivation For Creative Accounting:

Healy and Whalen [1999] summarize the major motivations to manage earnings which include Public offerings, Regulation, Executive compensation, and financial liabilities. Schipper [1989] provides a conceptual framework for analyzing earnings management from an informational perspective.


The managers are motivated for fixing financial statements for either managing position or profits. Following are important concerns for managers:

(a) To meet internal targets: The managers want to cook the books for meeting internal targets set by higher management with respect to sales, profitability and share prices.

(b) Meet external expectations: Company has to face many expectations from its stakeholders. The Employees and customers want long term survival of the company for their interests. Suppliers want assurance about the payment and long term relationships with the company. Company also wants to meet analyst’s forecasts and dividend payout pattern.

(c) Provide income smoothing: Companies want to show steady income stream to impress the investors and to keep the share price stable. Advocates of this approach favor it on account of measure against the 'short-termism' of evaluating an investment on the basis of the immediate yields. It also avoids raising
expectations too high to be met by the management.

(d) **Window dressing for an IPO or a loan:** The window dressing can be done before corporate events like IPO, acquisition or before taking a loan. (Sweeney (1994) reports the tendency of companies nearing violation of debt covenants is twice or thrice to make income increasing accounting policy changes than other companies).

(e) **Taxation:** The creative accounting may also be a result of desire for some tax benefit especially when taxable income is measured through accounting numbers.

(f) **Change in management:** There is another important tendency of new managers to show losses due to poor management of old management by some provisions Dahi (1996) found this tendency in US bank managers.

**Techniques of Creative Accounting:**

The potential for creative accounting is found in six principal areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgment in respect of assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers. Taking each of the six areas in turn:

1. **Regulatory flexibility.** Accounting regulation often permits a choice of policy, for example, in respect of asset valuation (International Accounting Standards permit a choice between carrying non-current assets at either revalued amounts or depreciated historical cost). Business entities may, quite validly, change their accounting policies. As Schipper (1989) points out, such changes may be relatively easy to identify in the year of change, but are much less readily discernible thereafter.

2. **Dearth of regulation.** Some areas are simply not fully regulated. For example, there are (as yet) very few mandatory requirements in respect of accounting for stock options.

3. **Management has considerable scope for estimation in discretionary areas.** McNichols and Wilson (1988), for example, examine the discretionary and nondiscretionary elements of the bad debts provision.

4. **Genuine transactions can also be timed so as to give the desired impression in the accounts.** As an example, suppose a business has an investment at historic cost which can easily be sold for a higher sales price, being the current value. The managers of the business are free to choose in which year they sell the investment and so increase the profit in the accounts.

5. **Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods.** This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

6. **Reclassification and presentation of financial numbers are relatively under-explored in the literature.**

**Existence Of Creative Accounting**

Proving the existence of creative accounting is far more different and complicated than discussing it. However, over these years, numerous research studies which examined creative accounting have come to

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the conclusion that supports its existence Even though managers' motivation for creative accounting may be established and accepted at least in theory, establishing empirically that it takes place is a separate problem. Naser and Pendlebury (1992) questioned senior corporate auditors about their experience of creative accounting. They were able to conclude that a significant proportion of all categories of companies employ creative accounting techniques to some extent. Many research studies examine a particular aspect or technique of creative accounting. All tend towards the conclusion that creative accounting using that particular technique does exist. McNichols and Wilson (1988) model the nondiscretionary component of the bad debts provision (so as to identify the discretionary element of the accrual). Barnea et al. (1976) discuss classificatory smoothing with the use of extraordinary items; their results, based on a study of 62 US companies, indicate that classificatory smoothing does take place. Moreover, this research found that the propensity to report in this way was significantly greater in non-owner managed firms.

Merchant (1990) examines management manipulation of accounting information within two firms (i.e. information used in internal reporting by divisions) drawing upon both interview and questionnaire data. The research found that 'managers acknowledged manipulative behaviours and short-term orientations'. Black et al. (1998) examine non-current asset sales as creative accounting tools, using a very large dataset of observations from Australia, New Zealand and the UK. They find that, where the relevant accounting standards are permissive (as in the UK up till 1993) managers will exploit the potential for creative accounting via timing of asset sales. Such behaviours are curtailed once the provisions of accounting standards are tightened. However, amongst their conclusions, they observe that 'there is every reason to believe that firms can “shift” creative accounting activity among a variety of methods'. So, even if certain loopholes in regulation are eliminated, creative accounting behaviour is likely to persist. Creative accounting behavior identified by Amat and others (2003) was relatively obvious based on the Spanish listed companies. In this study, there are 3 possible signs of creative accounting:

- Auditor report qualifications
- Changes in accounting policy
- Special authorizations to apply non-standard policy

Analysis of financial statements is an important step in this study to identify all creative accounting behaviors. The observation also show that the analyst' reports in Spain fail to include the existence of audit report qualifications and special authorizations of creative accounting practices. This research result shows that some elements of creative accounting practices are usual.

The Ethical Perspective

Companies desire to show the report with the profit grow steadily. This report is done by having stipulation for liabilities and opposing assets value during good years so that the reported profit can be improved in bad years. The purpose of this method is to evaluate the sources generate in following years and prevent unachievable expectations. However, the investors have the right to be informed on the violation of trading provisions and the effects of income smoothing in profit trend.

Revsine (1991) considers the main function of accounting is to supervise the contracts between managers and groups who provide the finance so that the market mechanisms function efficiently and able to pinpoint the possibilities in creative accounting. The text about the ethics of bias in the accounting policy regarding on creative accounting is evaluate at both 'macro' level of accounting regulator and 'micro' level
in the management of individual. Ruland (1984) differentiated the deontological view and teleological view which deontological view is where the moral rules apply actual actions whereas teleological view is action should be evaluated on the moral worth of outcome. However, Revsine (1991) tends to perceive deontological view in public sector and teleological view in private sector. Ruland (1984) also talk about difference between ‘positive’ responsibility and ‘negative’ responsibility. ‘Positive’ responsibility is the responsibility to exhibit unbiased account while ‘negative’ responsibility is the managers’ responsibility for the state of affairs which they fail to avoid. Ruland thinks that ‘duty to refrain’ that involve preventing the bias inherent in creative accounting is more critical because of the three issues which are relentlessness, certainty of outcome and responsibility.

Creative accounting seems morally doubtful for those professional accountants. According to Price Waterhouse senior partner’s observation (Conner1986:78), fraudulent reporting normally occurs among those above management level in which effective internal control are designed. Financial statement are commonly used to generate the delusion that company is in better condition than it actually is by misapplication of the accounting principles to cover the economic realities. Fischer and Rosenzweig (1995) and Merchant and Rockness (1994) discovered that accountants are favorable in violating the accounting rules while students are favorable in manipulating the transactions. The reasons are accountants may obtain rule-based approach to ethics and think that the violating of accounting rules is under their job scope which ethical judgment demanded.

Merchant and Rockness discovered that motivation of management impact the accountants’ attitudes to creative accounting. This motivation was to advance the company. Accountants and managers who protest the creative accounting might face the risk of ruining their reputation. Schilit (1997) reports case where the accountant's employer, food wholesaler who capitalizes the slotting expense and amortize it for ten years. The accountant noticed that the employer was against the accounting treatment. Therefore, he notified the auditors to force the company expense but amortize the slotting. The company unable to pursue the auditors approves the capitalization of slotting costs. Later, the accountant was set off for the reason contrast with the employer judgment. To avoid having the same fate with that accountant, there are some suggestions such as verify the acceptability of the accounting method and do not interrupt something which is legal to avoid offense. In addition, the accountant should present legal method to attain favorable outcome to the management and mistreatment should report to the appropriate supervisor.

The principal investor in the company tried, unsuccessfully, to put pressure on the auditor to support the capitalisation of the slotting costs. Shortly after the accountant was sacked for taking this stand. The series of actions in this case are revealing:

- Check that the proposed accounting method is in fact unacceptable. As Hamilton advises:
  
  First, try to verify your suspicions about what you think is wrong. Some accounting practices that are legal under new laws may look suspect to a non accountant... If you blow the whistle on something that's not illegal, you're really bare and perhaps even vulnerable to defamation claims. (1991:138-9)

- Search for alternative legitimate ways to achieve the desired end and offer these as an alternative approach to management.

- In the last resort, report the abuse to the appropriate monitor.
Suggestions:

It seems clear that in general creative accounting is seen as a deceitful and undesirable practice. In this section we analyse some measures which can help to reduce the scope for creative accounting practices, identifying, where applicable, recent developments in International Accounting Standards (IASs). IASs will become the standard for all European listed companies from 2005. Accounting regulators who wish to curb creative accounting have to tackle each of these approaches in a different way:

1. Auditor can play an important role in prevention and detection of creative accounting practices. If company’s auditor is well establish entity and has good track record then its auditing process may be trusted. But that

2. auditor should not be the only auditor of the company, there should be more then one auditor and that also should be rotated periodically. So that familiarity between company and auditor does not lead to decrease in objectivity

3. Proper system should be introduce to educate investors about the financial terms and its probable impact on financial position through providing booklet of methods adopted by the proposed company for various items in different situations and expected changes in special circumstances.

4. Existence of artificial entities should be carefully checked by its actual presence and actual business transacted through it

5. Companies which are allowed to enter into Indian market via mergers and acquisition or any other mode should be clearly examined; their financial statements should be checked through two or more independent auditors under the supervision of government for preventing fraudulent activities to come into Indian market.

6. Close examination of those transactions which are changed in special circumstances and reason behind it. And transactions with related parties should also be examine thoroughly.

7. Laws and regulations laid down by government should be strictly followed by imposing heavy penalties in case of non application of such rules.

8. Introduction of gifts and rewards for employees for their participation in management and motivate them to disclose any manipulations going on in the company records by anyone can also work in eliminating or reduction in creative accounting practices

9. Indian law has a major problem of slow trail and delay in investigation which reduced the materiality of the case and hence motivates others to follow the same practices. Through fast trial and quick investigation can reduce the number of accounting fraudulent practices.

Conclusion

Indian economy is not behind the other developed countries; in fact accounting fraud is prevalent more in developed countries. And in India such unethical practices are spreading its wings on fast pace just due to loopholes and weaknesses in accounting principles and standards. Through the study we found that companies are forced and under pressure of performing well and this becomes the major motivator of creative accounting, to be competitive

and be in the race of competition, companies are trying to do anything whether it is unethical. And thus creative accounting becomes convenient way of sustainability. Secondly, we also found that this problem may exist due to lack of awareness and information level of investors. Government need to take quick
action in awareness of the investors. Creative accounting practices are detected and prevented by various agencies such as SFIO and India forensic. Other countries should also take an adequate step in introduction of such law so that big accounting scandal like Satyam Computers can be eliminated from the economy.

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