Creative Accounting: An Overview

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Abstract

In recent years, creative accounting is becoming increasing popular running through companies, which lead to considerable allegation about the practice of creative accounting. Companies are able to manipulate the financial statements through various types of creative accounting techniques. It attracts more and more attention in the whole financial market and its presence distorts the true and fair view of the financial position of companies, and may cause serious corporate failure. When companies wish to reveal increasing profits and sturdy balance sheet, they may resort to creative accounting practices.

Keywords: Accounting, Earning Management, Corporate Governance

Creative Accounting is a practice in which company firstly estimates their financial position, and then works backwards in order to attain these desired figures. Companies are able to manipulate the financial statements through various types of creative accounting techniques. It attracts progressively attention in the entire financial market and its presence distorts the true and fair view of the financial position of companies, and may cause solemn corporate failure.

However, one can decisively assert that creative accounting is referred to as income smoothing, cosmetic accounting, earnings management, financial engineering and earning smoothing as alleged by the USA and Europe.

The common opinion of the authors is that the creative accounting is articulated by window dressing and reporting profits and assets in a way that is complimentary to the companies' shareholders and investors.

Objectives of the Study

The main objectives of the study are:

1. To develop understanding regarding creative accounting.

2. To understand the basic difference between creative accounting and earning management.
3. To identify the techniques of creative accounting.
4. To find out the objectives & benefits companies trying to achieve through creative accounting practices.
5. To indentify the potential pains and gains to the players by/ from creative accounting.
6. To state the suggestive measures to control such practices.

Creative accounting v/s Earning management

"Creative accounting and earning management are euphemisms for accounting practices that tend to circumvent, albeit, cleverly, or manipulate the rules of standard accounting practices or the spirit of those values" (Barnea, Chamberlain, and Marliton, 1976). Creative accounting also known as aggressive accounting is the process that deals with matters of accounting appraisal, conflicts items and events. This suppleness gives room for manipulation, deception and misrepresentation. The accountants use creativity sparingly and then rearranged the facts so that their financial statements comply with its primary mission and the faithfully reflects the economic reality of company at the end. "Creative accounting conceals financial risk, escape borrowing restrictions, circumvent shareholder controL heighten reported profits or mini:miz.e reported losses, manipulate key ratios used in market analysis and develop management recital" (Salome and Ifeanyi, 2012). Creative accounting practices are different from fraudulent practices and thus are not illegal but immoral in terms of misguiding investors.

Earning Management

An imperative technique sometimes applied in a company is earning management , which may be defined as a resolute intervention by management in the earnings determination process, usually to gratify self-centered objectives. "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." (Healy and Wahlen 1999).

Earning management occurs when manager use verdict in financial reporting and in structuring transactions to alter financial reports to either hoodwink some stakeholders about the underlying economic performance of a company or to influence contractual outcomes that depend on reported accounting numbers. Earning management involves artificial increase or decrease of profits, returns or earning potential of assets which is done with the help of aggressive accounting also known as creative accounting techniques. In applying earning management , company managers know the goals they are pursuing- by and large to the benefit of the company but not always to the benefit of stakeholders.

The main forms of earning management are as follows:

1. Incongruous revenue recognition
2. Inappropriate accruals and estimates of liabilities
3. Undue provisions and generous reserve accounting
4. Intentional minor breaches of financial reporting requirements that aggregates to material breach.

Techniques of Creative Accounting

Creative accounting can be applied by using all of any of the tools depending upon the objectives of using it.

1. Creating Multiple Trading Entities
2. Moving Business Segments Offshore
3. Recognition of premature or fictitious revenue
4. Aggressive capitalization and extended amortization policies
5. Oi.anging Depreciation Policy
6. Oi.anging Inventory Valuation
7. Deviation in Revenue Recognition Practices

The Objectives & Benefits Companies Trying To Achieve Through Creative Accounting

	Objectives	Benefits
1.	Share Price Effect	1. higher share prices 2. reduce cost of equity share capital 3. lower share price volatility 4. raise firm worth 5. increased value of stock options
2.	Profit Effect	1. raise capital from new share issues 2. propose their own shares in takeover bids 3. resist takeover bv other companies
3.	Borrowing Cost Effects	• relaxed or less rigorous financial covenants • perk up credit rating • reduce borrowin11; costs
4.	Political Cost Effects	• Decreased Regulations • prevention of Higher Truces
5.	Management Perlormance	• augmented Bonuses based on Profits/ Share Price

Source: 'The FinancialNumberGame by Cliarles W. MuHord &:Eugene E. Comiskey,2002"4

Potential Pains And Gains to the Players By/From Creative Accounting

	Playen	Pain&	Gai!UI
1.	Existing shareholders	1. Confidence in the market ▪	1. Higher the market value of their alwe8 2. Conlrolling employees claims 3. Lower the cost of capital 4. Reducing the volume of Tumsad:ian
2	Existing bondhalders	Wealth relocate to the actual Sharehclders ▪ ▪	Boo&!the market value of thei:r bonds Conlrolliru! emt>lovees claims
3	Managen	▪ Thejob and otatwo ▪	Lower the cost of capital ▪ Kee¢ng thei:r job ▪ Organizing their remuneration ▪ Respect the debts covenanlll ▪ Get laxadvanlage!I Offirlal examinatian Mmimizatian of inmmelax ▪ Acquire better relatians with the emnl""""" investam, and the creditar&
4	Employees	job from an uru-.oen ▪	Keeping !heirjobo ▪ Raise the remuneration
5	Suppliers	▪ Some money following an un.,....i;,....i • ▪	Maintaining their client
6	Clients	▪ notflattered ▪ Serv;ces brokenup Worrontieo	▪ w,.,......Tv.....-d Unremitting servk:es
7	a.nkers	Some money following an uruoreoeen bankru'DlcV	▪ Settlement of the loan
8	Society	Jobo loot and""'°"""" wBBIEd	Kee¢ng the job ▪ Production of wealth
9	State	▪ No mare lax IDcollect	Tax ID collect ▪ Jobs for neot>le

Suggestionsto Control Creative Accounting

InIndiacreative andfraudulent accounting canbereduced by:

1. Introducing forensic accounting for white collar fraud detection and prevention;
2. Plummeting the alternative choices of accounting treatment in accounting standards;
3. Enhancing the qualityof corporate governance;
2 .Amending Companies Act;
5. Enforcing strongregulation;
6. Appointing trulyknowledgeable Directors;and
7. Appointing those auditors having high standard of ethics and professional integrity.

Conclusion

Creative accounting practices are different from fraudulent practices and thus are not illegal but immoral in terms of misguiding investors. The practices, which are followed in manipulating the books, are duly authorized by accounting system and thus cannot be considered as violation of any rule or regulations. It is characterized by extreme compliance andthe use of novel ways of characterizing earnings,assets,or liabilitiesand the intent to influence readers towards the interpretations of desired results. It is not that creative accounting solutions are always wrong. It is the intention and the magnitude of the revelation which determines its true nature and justification. The impact of creative and fraudulent accounting can be reduced by streamlining the accounting and auditing system and more effective corporate governance.

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