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Creative accounting in financial reporting and its ethical perspective

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Abstract

Financial reporting is a process which communicates the financial information of a business organization to its users. User groups being too many, and for that matter the financial reporting process of companies have been frequently facing the hurdle of satisfying different such user groups with their diversified needs. Satisfying the desires of share holders regarding high profits, dividends may bring in problems of high taxes, demand for higher wages and bonus etc. On the other hand lower profit trend may have a negative image in the minds of the investors regarding investment choice. Therefore, this requires the accountant to maintain a balance in between according to the needs of the situation and therefore the companies resort to the practice of Creative Accounting.

The main objective of this paper is to define creative accounting used in financial reporting and to throw light on the ethical perspective of creative accounting.

Keywords: Creative Accounting, Income/Profit Smoothing, Financial Reporting

Introduction

Financial reporting is a process which communicates the financial information of a business organization to its users. User groups being too many, and for that matter the financial reporting process of companies have been frequently facing the hurdle of satisfying different such user groups with their diversified needs. Satisfying the desires of share holders regarding high profits, dividends may bring in problems of high taxes, demand for higher wages and bonus etc. On the other hand lower profit trend may have a negative image in the minds of the investors regarding investment choice. Therefore, this requires the accountant to maintain a balance in between according to the needs of the situation and therefore the companies resort to the practice of Creative Accounting.

The word 'Creative accounting in financial reporting sounds positive which to a lay person implies to be as creativity in accounting but it has tremendous negative aspects also. The term has been defined in a number of ways. Initially it may be defined as "a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the financial statements of a business". Such events cannot be revealed just by going through the annual reports published by an entity. The matter of Satyam Computers case- the unholy nexus between the top management of the said company and its statutory auditors was catching head line news.

Problems of contemporary financial reporting include its relationship with external auditing and the provision of assurance to those outside the reporting entity. After all, effective financial reporting and accounting, and external security from auditors, are essential for effective corporate governance. To understand the financial statements one needs to appreciate external auditors' work and opinion. Conversely, to understand auditors' work and opinion, it is necessary to appreciate the scope and limitations of the financial statements. More often financial reporting and external auditing are treated and discussed in isolation despite being inextricably linked. However, the final figures in the financial statements may come about as a result of negotiations between the management and their external auditors (as happened in Satyam case) - what should not be theoretically. Albeit, the external auditors are empowered by laws in our country to examine the reasonableness and management's justification for their representations but they are not empowered to alter figures of financial statements. Thus to understand the financial reporting in right perspective it is important to understand management's motivation. Financial reporting and auditing are

not just technical subjects, but they encompass a multitude complex judgments and assumptions.
The main objective of this paper is to define creative accounting used in financial reporting and to throw light on the ethical perspective of creative accounting.

2. Concept of Creative Accounting

There exist no globally accepted or legal definition of the term creative accounting. Some authors have defined it from their own perspectives. Each wrote from different perspectives, has explored the issue of creative accounting. (Griffith 1986) [1] Writes from the perspective of a business journalist and observes 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. 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. Whether it is legitimate or not but in most of the times this is manifested to total collapse of an entity. The existence of such practice may be possible to reveal only if an innovative accounting research can be carried out.
Jameson (1988) [2] writes from the perspective of the accountant and argues that "the accounting process consists of dealing with many matters of judgment and of resolving conflicts between competing approaches to the presentation of 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".
Smith (1992) [3] reports on his experience as an investment analyst, perceives that, "we felt that much of the apparent growth in profits which had occurred in 1980s was the result of accounting sleight of hand rather than genuine economic growth, and we set out to expose the main techniques involved, and to give live examples of the companies using those techniques".
Naser (1993) [4] presenting an academic view perceives that "Creative accounting is the transformation of financial accounting figures from what they actually are to what prepares desire by taking advantage of the existing rules and for ignoring some or all of them.
It is really interesting to observe that Nasar (1993) perceived the accounting system in the English speaking world are particularly prone to such manipulation because of the freedom of choice it permits. It is also observed that two features are common to the above researchers. That incidence of creative accounting is common and it is deceitful.

3. Techniques of Creative Accounting

Sometimes, the accounting rules allow a company to choose between different accounting methods. In many countries, for example, a company is allowed to choose between a policy of writing off development expenditure as it occurs and amortizing it over the life of the related project. A company can therefore choose the accounting policy that gives their preferred image [5].
Certain entries in the accounts involve an unavoidable degree of estimation, judgment and prediction. In some cases, such as the estimation of an asset's useful life made in order to calculate depreciation, these estimates are normally made inside the business and the creative accountant has the opportunity to err on the side of caution or optimism in making the estimate [6].
In other cases, an outside expert is normally employed to make estimates; for instance, an actuary would normally be employed to assess the prospective pension liability. In this case, the creative accountant can manipulate the valuation both by the way in which the value is briefed and by choosing a valuer known to take a pessimistic or an optimistic view, as the accountant prefers [7].
Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. Recently the matter of Satyam Computers may be taken as a glaring example of rampant cooking of accounts books, window dressing of financial reports. This is achieved by entering into two or more related transactions with an obliging third party, normally bank. For example supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. 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 [8].
Genuine transactions can be also be timed so as to give the desired impression in the account. As an example, suppose a business has an investment of rupees 1 crore at historic cost which can easily be sold for rupees 3 crore, 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 [9].

4. Reasons of Creative Accounting

Income smoothing is one of the aspects the companies follow for creative accounting. They prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. This is achieved by making unnecessarily high provisions for liabilities, or understating expenses and overstating assets. Sometimes positioning fictitious expenses into the profit and loss account and siphoning off the funds (as was done in case of Satyam computers). Such types of creative accounting is not only common in India (very few have been surfaced due to lack of adequate research) in this field of study, but also common in U.K. also Black *et al.*, (1995) [10].
A variant on income smoothing is to manipulate profit to tie it to forecasts. Fox (1997) [11] reports on how accounting policies at Microsoft Corporation, USA are designed, within the normal accounting rules, to match reported earnings to profit forecasts. When Microsoft sells software a large part of the profit is deferred to future years to cover potential upgradation and customer support costs. This perfectly respectable, and highly conservative, accounting policy means that future earnings are easily predictable.
Company management may keep an income-boosting accounting policy to distract attention from unwelcome news. Creative accounting may help maintain or boost share price both by reducing the apparent levels of borrowing and by creating the appearance of a good profit earning trend.
If the company directors engage in 'insider trading' in their company shows, they can use creative accounting to delay the release of information for the market, thereby enhancing their opportunity to benefit from inside information.

It should be noted that, in an efficient market, analysts will not be fooled by cosmetic accounting charges. Indeed, the alert analyst will see income-boosting accounting changes as a possible indicator of weakness.

5. Ethical Perspective of Creative Accounting

Companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. This is achieved 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. Advocates of this approach argue that it is a measure against the 'shorttermism' of judging an investment on the basis of the yields achieved in the immediate following years. It also avoids raising expectations so high in good years that the company is unable to deliver what is required subsequently. Against this is argued that if the trading conditions of a business are in fact volatile then investors have a right to know this and that income smoothing may conceal long-term changes in the profit trend.

Ruland (1984) [12] distinguishes between the deontological view whereby moral rules apply to actual actions and teleological view that an action should be judged on the basis of the moral worth of the outcome. Revsine (1991) [13] appears to take a teleological view of accounting in the private sector, allowing managers to choose between the various alternative policies to achieve their desired end. But to take a deontological view of accounting in the public sector tighter standards are advocated to prevent such manipulation.

Ruland (2007) [14] also discuss the distinction between a ‘positive’ responsibility means presentation of unbiased accounts, and a negative’ responsibility where the managers would be responsible for states of affairs they fail to prevent. As it is seen Ruland (2007) gives priority to the ‘positive’. Within Revsin’s-framework, where all outcomes are deemed to be impounded in the process of contracting and price-setting, the distinction is not acknowledged.

An accountant, or other manager, who takes a stand against creative accounting faces the same pressure as any other whistle blower despite it is absolutely unethical to resort to creative accounting path for the reason whatsoever. Creative accounting is a highly unethical practice which has been found to be exercised by majority of the corporate houses. The accounting system recognized in India and abroad has not allowed such practice while finalizing financial statements of a business enterprise. But in spite of that some business houses are inclining to adopt Creative Accounting practice. Application of such practice is betrayal to the investors and the customers. Hence it should not be endeavoured in any business organization.

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