Abstract—The study has been conducted to have a detailed view on creative accounting. A very important question has been tried to be answered in this study that why managers do creative accounting and how they become successful in performing such practice in the presence of stringent rules and procedures. Another aspect of creative accounting has been tried to be explored that whether this creative accounting practice is good for the companies or it brings companies in crises situation. Discussion based model has been used on the basis of past references and experiences. Link of governance with creative accounting practices has also been tried to be explored in the study. At the end it is concluded that the complex and diverse nature of the business transactions and the latitude available in the accounting standards and policies make it difficult to handle the issue of creative accounting. It is not that creative accounting solutions are always wrong. It is the intent and the magnitude of the disclosure which determines its true nature and justification.

Index Terms—Creative accounting, earnings management, corporate governance.

I. 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. Study wishes to propose today that creative accounting is a tool which is much like a weapon. If used correctly, it 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. Creative Accounting has helped more companies to get out of a crisis than land them into a crisis. The weapon is almost always innocent; the fault whenever it emerges lies with the user. Coming from a developing country where stock exchanges listings often fail to reflect the true credentials of a company, there are many cases where companies have benefited tremendously by using creative accounting techniques and remained afloat during difficult times.

Before we go into jargon and intricacies of the subject, let me relate an episode from Pakistan’s cement industry. In mid-nineties, the country suffered an acute shortage of cement. The government announced a number of incentives for new cement plants and as a result a number of new plants were planned—seven to be precise. The combined production of these and existing plants was expected to meet the demands of cement for the country as well as leave a surplus for export to its neighbors like Afghanistan and India who are always short of this product. It takes three years for a cement plant to start production. By the time the new plants came into production in late nineties, the country’s economic scenario had changed. The government had no money for development, the economy was generally in recession, and construction had virtually come to a halt. With tremendous overcapacity, the cement prices started falling precariously. The companies got together and slashed production. Plants started operating at an average of around 22% production capacity to ensure that prices do not fall. The prices drop stopped but still it did not help much. Now cement is one industry where the largest slice of costs is fixed and time related, rather than operations related. As much as 72% of annual costs of a new cement plant may comprise of only two items namely depreciation and interest. Both of these are fixed and computed on the basis of time. As a result, a low capacity utilization meant higher cost per ton of cement produced in any period, leading to huge losses. One 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 end, 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 the profitability figures. This had no implication for corporation taxes as depreciation is not a tax allowable expense virtually anywhere in the world. So using a creative accounting tool, the companies were able to show profits, or minimize losses, during a difficult period when the capacity utilization was low. This enabled them to keep the investors reasonably comforted and the staff relaxed. The interesting thing is that when the demand rose and 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 of cement plants were able to pull through a crisis.

Now lets have a view on some technical aspects of this phenomenon.

II. SOME DEFINITIONS OF CREATIVE ACCOUNTING

Creative Accounting refers to the use of accounting knowledge to influence the reported figures, while remaining within the jurisdiction of accounting rules and laws, so that instead of showing the actual performance or position of the company, they reflect what the management wants to tell the stakeholders.

“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”. [1]

“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.” [2]

Many terms can be used to describe the practices of changing the facts in accounting, e.g. cooking the books, aggressive accounting, massaging the numbers, window dressing, earnings management, etc.

### Common Labels for Financial Numbers Game

<table>
<thead>
<tr>
<th>Label</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggressive Accounting</td>
<td>A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with GAAP or not.</td>
</tr>
<tr>
<td>Earnings management</td>
<td>The active manipulation of earnings toward a predetermined target, which may be set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream.</td>
</tr>
<tr>
<td>Income Smoothing</td>
<td>A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and “store” profits during good years for use during slower years.</td>
</tr>
<tr>
<td>Fraudulent financial reporting</td>
<td>Intentional misstatements or omissions of amounts or disclosures in financial statements, done to deceive financial statement users, that are determined to be fraudulent by an administrative, civil, or criminal proceeding.</td>
</tr>
<tr>
<td>Creative accounting practices</td>
<td>Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earnings management or income smoothing.</td>
</tr>
</tbody>
</table>

Unfortunately, all the above definitions imply a misuse of creative accounting techniques for the purpose of deception or attaining dishonest ends. While this may be applicable to many of the situations, I believe that it is not true of all the companies.

### III. Motivation for Creative Accounting

[3] summarize the major motivations to manage earnings which include Public offerings, Regulation, Executive compensation, and financial liabilities.[4] provides a conceptual framework for analyzing earnings management from an informational perspective.

[5] added insider trading in this list of motives. Managers aware of misstatement of profits can benefit by trading the securities,[6] suggest three broad objectives for earnings management: minimization of political costs; minimization of the cost of capital and maximization of managers’ wealth.


[8] find that firms manage earnings prior to seasoned equity offers and IPO’s. [9] conclude that firms manage earnings to meet financial analysts’ forecasts.

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 meat 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 prices stable. Advocates of this approach favor its account on 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. [10] 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. [11] found this tendency in US bank managers.

### IV. Importance

Creativity in accounting can be bad, that doesn't mean that it must be bad. If creative accounting coheres 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 may help maintain or increase the share price by decreasing debt level to lower risk and by showing improved profits. The high share price can help the company in raising new capital and in takeover attempts.

Some authors believe that if management delays the release of financial information to the market, with an intention of taking some advantage from the delay, that also falls within the meaning of creative accounting. Once again, if the intentions are not to harm any stakeholders’ interest, this can hardly be described as dishonest.

According to [12], [13] earning management techniques reduce the variability of earnings and, therefore, shareholders benefit because the reduced uncertainty and improved predictability of future earnings help in enhancing price/earning multiples. However, they claim that abnormal accruals over time tend to reverse and are readily detected by investors. This clearly calls for moderation in using even healthy techniques for managing earnings.

V. EXPERIENCE FROM THE WORLD

Unreasonable and dishonestly excessive use of Creative Accounting led to the downfall down of numerous high-profile companies in the United States during the great depression. This gave rise to the need for developing GAAP. Recently, the Great Giants like Enron failed as a result of cooking the books to hide the economic substance.

One example is US film industry which claims huge expenses against successful movies to lower the remuneration of writers, producers, and actors [14]. [15] reports on how a change in accounting method boosted K-Mart’s quarterly profit figure by some $160 million, by a happy coincidence distracting attention from the company slipping back from being the largest retailer in the USA to the number two slot.

VI. FUNCTIONING OF CREATIVE ACCOUNTING

Accounting standards do not cover all aspects and many methods are present for one treatment. e.g. there are more than one method of valuation of inventory or method of depreciation. Secondly, there is discretion available to management on any particular method.

A. MISUSE OF ACCOUNTING POLICIES

As stated above, the accounting standards and policies cannot cover every aspect of business transactions. Therefore considerable latitude is available to companies to play within the legal ring. The commonly cited example of misuse of accounting policies includes exploiting the loopholes in revenue recognition standards. There is a wide debate on this issue among accounting policy makers, standard setters and practicing companies as when to recognize and record the revenue in the book of accounts.

So, it is a common practice to book revenue even before recognizing it to increase the profits.

Sometimes companies do no wants to show a profit above a certain level, in that case companies defer revenue to reduce their profits.

Timing of expense recognition is used in the similar manner to achieve the desired objectives i.e. either to show increased profits or decreases profits.

B. CHANGES IN ACCOUNTING POLICY

Due to the latitude available in accounting policies, companies can alter their profit figures by changing the accounting policy and deliberately omit to mention the change in policy in notes or omit to give correct impact of the change. For example

Changing the closing stock valuation method and do not inform the readers of the financial statements that what impact either positive or negative it could have on earnings.

Change the rate of depreciation method or change the method itself to increase or decrease the depreciation expense.

VII. HOW TO DELIBERATELY PRESENT A FALSE PICTURE

A company wishes to show higher profits, it has number of options to achieve this objective.

- It can overvalue its closing stock thus by decreasing the cost of goods sold; it will show increased profit and on the other hand increased total assets in the balance sheet.
- By ignoring the provisions for bad debts /legal obligations, the current profits can be overstated.
- It can book false gains through sales purchase back. For example if company owns a piece of land which were bought, let us say, 30-40 years ago at a cost of Rs. 150,000. Now the company is bound to show the cost of this piece of land on historical basis as required by accounting standards. If the current market price of that piece of land is say approx. 30 million, the management can sell this land to someone on pre-decided terms to purchase it back. By executing this under the table transaction, the company balance sheet footing will be increased by Rs 30 million. Now that the company would have legally bought the property at Rs 30 million, it will be justified to show it in the balance sheet at that amount (being the cost).
- Playing with debits and credits

If we talk purely in accounting language, the entire accounting process is about the correct use of “debits”
and “credits”. In the very first course of accounting, students are taught how the five main items of assets, liabilities, equity, revenue and expenses are treated in the books of accounts. The below given table explains for the readers that if an item increases or decreases how this will be treated in the accounting journal.

<table>
<thead>
<tr>
<th>Account Type</th>
<th>Increase is Recorded By</th>
<th>Decrease is Recorded By</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Expense</td>
<td>Debit</td>
<td>Credit</td>
</tr>
<tr>
<td>Revenue</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>Liability</td>
<td>Credit</td>
<td>Debit</td>
</tr>
<tr>
<td>Equity</td>
<td>Credit</td>
<td>Debit</td>
</tr>
</tbody>
</table>

The foundation of the entire accounting edifice stands on these two simple words: debits and credits. Debits are used to record expenses (or reduction in revenue) and to record assets (or reduction in liabilities or capital). Similarly, credits are used to record revenues (or reduction in expenses and to record liabilities (or reduction in assets). A debit will either end up in the Income Statement (i.e. if it is treated as an expense) or in the Balance Sheet (i.e. if it is treated as an asset). Quite similarly, a credit will end up in Income Statement if it is treated as revenue or in Balance Sheet if it is treated as a liability. Now, a creative accountant can mischievously play with these basic rules to procure his desired result. Accountants on demand of management or owners artistically manipulate these instruments to get the desired results. An expense may be treated as an asset to improve book profits, or alternatively an asset may be expensed to show lower profits. Similarly, a revenue may be transferred to a liability (through provisioning) to reduce book profits, or a liability may be dressed up as a revenue to show higher book profits virtually at the whims of the accountant.

A. Big Bath Charges

In this technique, instead of showing losses for a couple of years, a big loss is shown for a single year by charging all expenses in that year. This may be done if there are apparent reasons for poor profitability in that year and the management feels that by lumping all expenses in one bad year, they can start showing better profits in following years.

B. Creative Acquisition Accounting

IFRS 3 provides extensive guidelines on how the purchase price of business acquisitions should be allocated. The SEC also has a check on allocation of R& D costs. Yet it leaves room for manipulation of amortizing levels.

C. Cookie Jar Reserves

Over-provisioning for accrued expenses when revenues are high helps to bring down profits to a level that is safe to maintain in the future. Similarly, failure to provide all the accrued expenses can help show larger profits during tougher times when such is the need of the hour.

D. Materiality

A change in an immaterial item can help the firm billions of dollars. For example, some companies do not recognize an expenditure under say $5000 as an asset, even if its benefits is likely to be spread over several years. Varying this limit to say $2,000 can easily increase profits while hiking up this limit may lead to lower profits.

E. Revenue Recognition

Firms virtually have a free hand in timing the booking of their revenues at any stage starting from the moment sales contracts are signed till the promised product or service has been fully delivered to and accepted by the clients. For this we can refer to a classic example of Microsoft which was heavily fined by US SEC for its manipulative revenue recognition policy. Microsoft recognized only a small percentage (20-30%) as revenue at the time of the sale and remaining amount was kept as provision for future after sales services. Why Microsoft adopted that strategy. The answer is to (1) hide substantial profits, (2) signaling effects, (3) avoiding complacency and last but not the least (4) to report smoothed earnings to its shareholders & stakeholders.

VIII. CREATIVE ACCOUNTING TECHNIQUES

The basic model for recording transactions and events in the books of accounts, under the double entry system, is as follows:

All the techniques of Creative Accounting revolve around the basic process of “debiting and/or crediting an inappropriate account” when recording a transaction or an event. By implication, the process also covers “not debiting and/or crediting” the correct account with the correct amount.”

A. Example 1

A payment is made for repairing the factory wall. This is an expense item as this payment does not improve the value of the factory buildings; it merely restores it to the previous value. Now if this payment is debited to Factory Premises Account, it will result in an over-statement of an asset and
an understatement of an expense. In turn, this will lead to over-statement of relevant year’s Net Profit and over-statement of assets in its balance sheet.

B. Example 2

A payment is made for constructing a new shed in the factory. This is a capital expenditure as it increases the value of factory buildings. Now if this payment is debited to Factory Premises Repairs and Maintenance Account, it will result in an over-statement of an expense and an understatement of an asset. In turn, this will lead to over-statement of the total assets in the balance sheet and understatement of relevant year’s net profit.

C. Example 3

The unsold inventory at the end of a year is over-valued. For the companies that do not maintain integrated cost and financial ledgers, the entry made to bring the value of closing inventory to ledger is Debit Inventory Account and Credit Cost of Goods Sold Account. If the closing inventory is over-valued, it will result in over-statement of the assets in the balance sheet and under-statement of an expense (Cost of Goods Sold) in the Income Statement.

Conversely, if the unsold inventory at the end of the year is over-valued, it will result in under-statement of the assets in the balance sheet and over-statement of an expense (Cost of Goods Sold) in the Income Statement.

D. Example 4

A company decides not to provide any depreciation on a particular fixed asset that was acquired during the year, on whatever pretext. This means the Depreciation Expense account (and Income Statement) will not be debited and the asset account (or Provisions for Depreciation Account) will not be credited. This will lead to over-statement of year’s net profit and over-statement of the assets in the balance sheet.

A variation of this example, ending in similar misstatements, could be where the company decides to provide less than the due amount of depreciation for the year.

Conversely, a company may decide to provide a whole year’s depreciation on an asset that was bought towards the end of a particular year and used for only a short period. This means the Depreciation Expense account (and Income Statement) will be over-debited and the asset account (or Provisions for Depreciation Account) will be over-credited, leading to showing higher expenses in the Income Statement and under-stating the assets in the Balance Sheet.

E. Example 5

A company receives an order for supply of goods in the future, along with an advance payment. Now the advance amount is a liability till the company actually delivers the goods and the same are accepted by the buyer. If the company decides to credit the advance amount to Sales Account, it will lead to over-statement of income in Income Statement and an under-statement of liability in the Balance Sheet.

A variation of this example may be where an inappropriate amount is credited to sales revenue account which may not correspond to the correct sales value of goods actually delivered during the year.

Yet another variation relates to treatment of sales (or similar) tax. If a company sells goods for say $100 that attract a sales tax of $16, the entry should be debit cash or receivables $116, credit sales $100 and credit Sales Tax Payable $16. However, a company may opt to credit the entire amount of $116 to sales revenue, thereby treating a liability of $16 as a revenue for the year. When the company actually pays the sales tax to relevant tax authorities in the subsequent accounting period, it may debit Sales Tax and credit cash, treating it as expense of that period. Effectively, this means that the sales of the current period are over-stated while a liability is not shown in the period-end Balance Sheet. It also means that a current period’s cost (sales tax, $16) is transferred to the next period.

F. Example 6

Companies (e.g. computer software sellers, motor vehicles manufacturers, etc.) that supply goods that are covered under some sort of warranty, often do not credit the entire sales proceeds to sales account. They transfer a part of the sales revenue to a Provisions Account, ostensibly to be debited with the costs associated with the claims against current year’s sales received in subsequent accounting periods. However, in practice they do not actually debit costs related to claims to the provisions account; they continue to debit all costs to nominal accounts, even if they relate to goods supplied in previous years. Creation of unnecessary or unjustified provisions means a revenue item is being treated as a liability, i.e. sales revenue account is under-credited and provisions account is over-credited and shown in the Balance Sheet as a liability.

IX. ROLE OF GOVERNANCE IN CREATIVE ACCOUNTING

Corporate governance is about giving to the managers a unique objective: maximizing the profits and dividends. Corporate governance is, thus, the end of the managers’ era. [16]

An important area of corporate governance is to check that company is providing the timely, fair and appropriate disclosure of all activities to all stakeholders.

A. Possible role of Governance in Creative Accounting

Current accounting rules under International Accounting Standards and U.S. GAAP allow managers some choice in determining the methods of measurement and criteria for recognition of various financial reporting elements. The potential exercise of this choice to improve apparent performance increases the information risk for users. Financial reporting fraud, including non-disclosure and deliberate falsification of values also add to users’ information risk. To reduce these risks and to enhance the perceived integrity of financial reports, corporation financial reports must be audited by an independent external auditor who issues a report that accompanies the financial statements. In addition, the audit committee of the Board, comprising of independent non-executive directors, can play an effective role to prevent misuse of creative accounting techniques and observance of ethical standards in financial reporting.

[17] studied the impact of Corporate Governance on
creative accounting for Chinese companies. His study showed a decrease in earning management after the regulation of code of corporate governance. With respect to ownership concentration, state ownership is more involved in dressing up the books than the privately owned firms. Independent non-executive directors on the board and the audit committee and the accounting/financial experts sitting on the audit committee also helped in checking the manipulation of accounts.

X. CONCLUSION

To sum up the discussion on creative accounting practices, it is an unfortunate situation that we cannot completely restrict or stop the misuse or abuse of creative accounting practices. The improper use of such creative accounting practices had fooled both auditors and regulators in the past (e.g. Enron, Bank of Punjab etc) and it continues to do the same. The complex and diverse nature of the business transactions and the latitude available in the accounting standards and policies make it difficult to handle the issue of creative accounting. It is not that creative accounting solutions are always wrong. It is the intent and the magnitude of the disclosure which determines its true nature and justification.

REFERENCES