



Creative Accounting: An Innovative Financial Strategy for Management

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Abstract

Creative accounting, often described as the art of manipulating financial statements within the boundaries of accounting standards, remains one of the most controversial practices in the corporate world. While it is frequently used to present an improved picture of a company's financial performance or position, it raises significant ethical and legal questions. This paper explores the concept of creative accounting, shedding light on the motivations behind its use with real-world examples of companies that have employed creative accounting strategies, the techniques employed, and the broader implications it has for stakeholders and the financial ecosystem at large. The ethical and legal aspects of creative accounting are also discussed in this paper to deepen understanding of both its appeal and its risks.

Keywords: *Creative Accounting, Financial Strategy, Fraud, Legal and Ethical Implications.*

Introduction

Creative accounting involves a set of legally permissible accounting activities and practices that are not widely accepted or practiced. These practices are carried out to make a company appear either more financially healthy or weaker, depending on

management's goals. Creative accounting is also called cooking the books, income smoothing, earnings management, financial engineering, cosmetic accounting, window dressing, or big bath accounting. It involves changing accounting figures from their actual values to what the perpetrators want, by exploiting existing rules and sometimes ignoring others (Gosh, 2010; Kamal & Naser, 1993). Creative accounting has been around for a long time, with managers in various countries using the system to mislead investors. Even though accounting standards exist, accountants often find ways to manipulate financial information through various means.

The practice of creative accounting is not only a costly task but also a risky one. Arpoff, Lee, and Martin (2008) show that, on average, companies lose 38% of their market value when financial misrepresentations are publicly disclosed. Thus, firms need to be very careful when engaging in manipulative behaviour. Managers will manipulate as long as the gain contributed by this manipulation is higher than the costs. The gains are in many forms and bring in new investors into the firm.

Some authors argue that creative accounting is a collection of techniques, options, and flexibility left by accounting regulation, without violating laws or accounting standards, enabling managers to alter the financial results or statements. Creative accounting also refers to using accounting knowledge to influence reported figures, while staying within the boundaries of rules and laws, so that instead of showing the company's actual performance or position, they reflect what management wants to communicate to stakeholders.

Objective of the Study:

- The primary objective of this paper is to provide a comprehensive overview of the concept of creative accounting and its implications.

Creative Accounting versus Fraud

Manipulation that does not violate laws and standards is considered fraud, according to Diana and Madalina. Engaging in creative accounting or manipulation accounting is lawful and therefore not regarded as fraud. Fraud occurs when a company

commits an illegal act, such as falsifying invoices to boost sales figures. However, making false estimations about bad debts is not considered fraud.

According to Belkaoui (1989), real fraud is defined as 'falsifying or altering documents, deleting transactions from records, recording forged transactions, or concealing significant information'. Due to the difficulty of the distinction between the two, the commission responsible for fraudulent financial reporting defined fraud as 'materially misleading financial statements' (NCFRR 1987).

Thus, it is said that creative accounting deals with the misrepresentation of accounting figures by following the standards set by the accounting conventions, while fraud is the falsification of accounting figures made by disobeying the law.

Table 1: Summary of Some Cases of Creative Accounting in India

Company	Year	Nature of Creativity
Satyam	1999-2009	Unethical manipulation of accounts and fraudulent transactions led to the downfall of the company. Mr. Ramalinga Raju was fudging revenue figures every year, and thus, the gap between actual profit and book profit widened every year. He raised fictitious bills for services that were never rendered. He also increased the cash and bank balances accordingly. Operating profits were artificially boosted from the actual ones. The Income Tax department is independently probing the accounting fraud in Satyam with a focus on tax deducted at source and BENAMI Deals.
Wipro Ltd.	1996-97 to 1999-2000	Transfer of land to stock-in-trade, creating capital reserve to boost net worth and to neutralize the effect on profit of the reduction of land value.
Larsen & Toubro Ltd.	1999-2000 & 2001-2002	Income recognition through the transfer of loan liabilities at a lower consideration.

Bombay Dyeing and Manufacturing Company	2003-04 & 2004-05	Creating provision for possible loss on firm purchase contract and subsequent write-back of such provision, thereby converting operating losses into operating profit.
Adani Group	2023-2024	Adani Group, a conglomerate based in India, has been accused of employing various accounting techniques to manipulate its financial statements. One of the primary methods employed by the company is the overstatement of revenues by fictitious sales.
Hindustan Zinc Ltd	2003-04 & 2004-05	Reclassifying investments into tangible assets to blend with the requirement of the valuation of investments.
ONGC Ltd.	2004-2005	Capitalization of interest as well as other intangible assets to show fixed assets value upward and understating revenue expenses.

(Source: Global Data Services of India Ltd., Accounting and Analysis: The Indian Experience. 2006.)

Reasons behind the Creative Accounting

Creative accounting is practiced in order to align the interests among different are more likely to have income-increasing, depreciation policies and bad debt allowances, thus to report a higher amount of income, consequently to show that the firm is profitable, which will then attract investors to invest in the firm by buying stocks.

Furthermore, DeGeorge, Patel & Zeckhauser found that it is crucial for firms not to make losses and to achieve consistent earnings growth. Achieving a consistent earnings growth is achieved by smoothing the reported earnings. Income smoothing occurs because companies would rather report a steady growth in profits over time than losses in bad periods. It can be done by making unnecessarily high provisions of liabilities and against asset values in good years, so that the provisions are reduced, and consequently, in bad periods, the reported profits will be improved. The main reason for this kind of practice is due to the fact that investors prefer to pay a premium for stocks with steady

and predictable earnings streams, compared to earnings that are subject to fluctuations. The main reasons for creative accounting generally fall into one of these areas:

➤ **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.

➤ **Meet External Expectations:**

The company has to face many expectations from its stakeholders. The employees and customers want the long-term survival of the company for their interests. Suppliers want assurance about the payment and long-term relationships with the company. The company also wants to meet analysts' forecasts and dividend payout patterns.

➤ **Provide Income Smoothing:**

Companies want to show a steady income stream to impress investors and to keep the share prices stable. Advocates of this approach favor it on account of measures 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.

➤ **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 that the tendency of companies nearing violation of debt covenants is twice or thrice to make income-increasing accounting policy changes as other companies.]

➤ **Taxation:**

The creative accounting may also be a result of a desire for some tax benefit, especially when taxable income is measured through accounting numbers.

➤ **Change in Management:**

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

This manipulative behaviour occurs through different situations, depending on what the company is looking for at the time, but the main reason is to falsify the records so it can be attractive to the public, which will consequently encourage investors to buy stocks and increase the firm's value.

Table 2: Some Common Techniques Used in Creative Accounting and Their Impact on Financial Statements.

Sl. No.	Creative accounting practices	Impact on financial statements
1	Increasing or reducing expenses with provisions and adjustments for depreciation.	Reducing or increasing profit, internal capital, assets, and liabilities
2	Changing various elements of the depreciation policy, such as the method, the duration, or the residual value.	Reducing or increasing profit, internal capital, and assets
3	Including or not certain expenses in the asset production or purchase cost.	Reducing or increasing profit, internal capital, and assets
4	Selecting fixed assets that will be included in the re-evaluation process	Reducing or increasing profit, internal capital, and assets
5	Assessing transactions with entities from the group at different prices than market prices or price falsification.	Increasing or reducing the profit, internal capital, of other assets and liabilities
6	Accounting expenses are based on the retained earnings instead of including them in the profit and loss statement.	Increasing profit.
7	Extra-balance financing on account of branches not included in the consolidation. Perimeter.	Reducing Liabilities.

8	Changes in the stock valuation methods.	Reducing or increasing profit, internal capital, and assets.
9	Accounting transactions are made by making future optimistic or pessimistic estimates.	Increasing or reducing profit, internal capital, or other assets or liabilities
10	Creating extraordinary results by showing sales of fixed assets, costs, or revenues from previous years.	Increasing or reducing profit, internal capital, or other assets or liabilities
11	Anticipating the recognition of revenues or postponing the identification of expenses.	Increasing profit and internal capital
12	Postponing the recognition of revenues or anticipating the identification of expenses.	Reducing profit and internal capital
13	Fictive sales.	Increasing profit, internal capital, and assets.
14	Compensating assets with liabilities or expenses with revenues.	Increasing or reducing profit, internal capital, of other expenses and revenue.
15	Taking into account the research-development costs, after the commissioning of assets or costs of debts, as expenses for the period, or their capitalization.	Reducing or increasing the profit of internal capital and assets.
16	Changes to the holdings classification policy	Reclassifying assets and liabilities.
17	Lease-back operations, sales of assets, and immediate takeover of the location	Increasing profit, internal capital, and reducing assets
18	Production of fixed assets	Increasing profit, internal capital, and assets

While some methods may technically meet accounting standards, they often undermine the spirit of transparency and fairness that supports financial reporting.

Review of Literature on Creative Accounting

Salome, et.,Al. (2012) in their article entitled “The Effect of Creative Accounting on the Job Performance of Accountants (Auditors) in Reporting Financial Statements in Nigeria” finds that the creative accounting practices affected the quality of financial reporting. The practice of creative accounting is ethically dubious and significantly influences both accounting policy choice and the manipulation of transactions in financial reporting.

Yadav, Kumar, and Bhatia (2014) in their article try to show the effect of creative accounting on the performance of the company which uses these techniques to manipulate their accounts to show desired results and suggested that the effect of creative accounting can be minimized by Corporate Governance and fixing the ethical behaviour of Auditors.

Shah, Butt and Tariq (2011) conducted a study to have a detailed view on creative accounting and based on the study 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.

Hosho, Matowanyika, and Chinoda (2013) identified the need to assess the value of the internal audit function in detecting creative accounting-related frauds in the Zimbabwean cotton industry, particularly in the pre-dollarization era. Chi-Square Tests were used to analyse the data. Statistical tests for relatedness between the internal audit function and fraud detection were done. Empirical evidence suggests that more internal audit visits, more reported frauds.

Momani and Obeidat (2013) in their study aim to investigate the effect of audit ethics on auditors’ ability to detect the practices of creative accounting. The multiple linear-regression method was used in testing the last hypothesis. The study found that ethical rules affect auditors’ ability to detect the practices of creative accounting.

Kamau, Mutiso and Ngui (2012) in their study aimed to provide evidence of the practice of creative accounting for the purposes of evading and avoiding tax among companies in Kenya and the study established that tax avoidance and evasion is indeed one of the major factors contributing to practice of creative accounting among companies in private sector in Kenya.

Osazevbaru and Osahon (2012) in their paper titled "Creative Accounting and Firm's Market Value in Nigeria" try to find out if creative accounting practice obtains in Nigeria, and whether such practice enhances a firm's value. It is found from the study that creative accounting practice obtained in Nigeria positively affects a firm's value, which can also impact on its share price. The study suggested that the Accounting Profession in Nigeria needs to give much importance to ethical codes.

Patnaik, Satpathy, and Das (2014) in their study attempted to understand the various tools that are used for these creative accounting in Kolkota of West Bengal and Bhubaneswar & Cuttack of Odisha. The study found that window dressing practices are prevalent in the majority of corporations, but it also depends on the expertise and knowledge of the accounting department. Moreover, it is also found that the external auditors, to some extent, encourage these practices for their own interest.

Legal and Ethical Implications of Creative Accounting

The deliberate manipulation and distortion of financial statements can lead to severe legal consequences, such as fines, lawsuits, and even criminal charges. Some of the important implications are as follows:-

- **Violation of accounting standards and regulations:** These Violations undermine the integrity and reliability of financial statements, making it difficult for stakeholders to make informed decisions. It is crucial for organizations to maintain trust and confidence in the financial reporting process.
- **Breach of trust and fiduciary duty:** Breach of trust and fiduciary duty is a significant consequence of creative accounting practices. When companies manipulate their financial statements, they breach the trust of their stakeholders, including shareholders and investors. Furthermore, these

practices violate the fiduciary duty that companies have towards their stakeholders to act in their best interests and provide accurate and transparent financial information.

- **Legal consequences and reputational damage:** These are significant outcomes of engaging in creative accounting practices. Companies found guilty of manipulating financial statements may face hefty fines, legal penalties, and even criminal charges. Furthermore, these unethical actions tarnish a company's reputation, leading to a loss of trust and credibility among investors, stakeholders, and the public. The long-term consequences of such misconduct can severely impact the financial viability and sustainability of a firm. Hence, the consequences of this unethical behavior can be severe, including erosion of investor confidence, increased audit scrutiny, and legal repercussions. Furthermore, it can distort the true financial health of a company, misleading investors into making uninformed decisions.

Opportunities for Further Research in Creative Accounting

Creative Accounting is a burning issue in the field of accounting because, with its use many companies cheat their stakeholders and fail in the market. Many accounting scandals all over the world have taken place where the use of creative accounting has been identified. Some argue that it is useful for the company while others argue that it is harmful for the company, but no one knows its exact answer. Many researches have been conducted relating to the various aspects of creative accounting in many countries all over the world. But in India, a few studies have been done on it. As a result, its scenario in the Indian context is not well known to all. Its various factors like major creative accounting tools and techniques used in India, its status in the Indian market scenario, its usefulness, its impact, reasons for creative accounting, and what may be the probable solution to it? Various professionals' views regarding this, etc. provide some scope for research in India.

Conclusion

The subject of Creative Accounting is usually depicted as a false representation of accounts. When the words “Creative Accounting” are mentioned, the image that comes to mind is of manipulation, dishonesty, and deception. In reality, creative accounting is a tool that is much like a weapon. If used correctly, it can be highly beneficial to the user, but if misused or in the wrong hands, it can cause significant harm. Creative Accounting has helped many companies avoid crises rather than cause them. The weapon is almost always innocent; the fault, whenever it appears, lies with the user.

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