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Creative Accounting Leading to Financial Scams-Evidences from India and USA

Dhanesh Kumar Khatri*

Abstract

Creative accounting is practically using the flexibility provided within the accounting principles or accounting standards to manage recognition, measurement and presentation of different accounting figures to serve the purpose of those who prepare the accounts rather than those who are likely to use the accounts. Application of creative accounting skills beyond a certain limit leads to financial scam.

In the recent past just before Satyam scam was unearthed Satyam's employee roll revealed that around 50,000 people were employed in Satyam and US GAAP statement of Satyam as on 31st March, 2008 disclosed a bank deposit of Rs. 3,400 crores. It raises an eyebrow on the role of statutory auditor Price Waterhouse Corporation (PWC). What as an auditor they were doing? Why didn't they verify the balance with the banker?

Accounting scandal of Enron was revealed in October 2001 leading to the bankruptcy of Enron Corporation and dissolution of one of the auditors of Enron namely Arther Andersen. Story of Enron scam is not only the biggest scam in the corporate world of USA but also a biggest question mark on the accounting and auditing regulation in the country like America.

Despite of the facts that both of these companies were considered to be good at corporate governance still their owners i.e. promoters/directors self-centered greed led to financial scam. This shows that good governance is only an ornament to cover the ugly face of dirty financial statements.

Keywords: creative accounting, window dressing, earning management, financial scam.

I. INTRODUCTION

Use of certain accounting techniques to present the financial position of a company in a favorable manner or in a desired direction is called application of creating accounting for window dressing of accounts. In creative accounting either profits or assets are inflated or deflated with the objective to hide the real financial performance and position so as to benefit a particular class of stakeholders. Creative accounting is practically using the flexibility provided within the accounting principles or accounting standards to manage recognition, measurement or presentation of different accounting facts to serve the purpose of those who prepare the accounts rather than of who are likely to use these accounts.

Apart from using the flexibility provided by the accounting principles and accounting standards few accountants go beyond it by means of manipulation and misrepresentation of facts to project and present desired financial performance in terms of profit/loss, assets and

* Professor and Head, Department of Finance, Institute of Management Studies, Faculty of B.J.S. Rampuria Jain College, J. N. Vyas Colony, Bikaner-334003, India. Cell number: +91-98297 71911. Address: C-41, Kanta Khaturia Colony, Bikaner-334003, Rajasthan, India. E-mail: dhaneshbikaner@gmail.com.

liabilities. This manipulation and misrepresentation leads to fraud or falsification of facts leading to accounting scams.

1.1. Focus in Creative Accounting

The main focus of window dressing is around following aspects.

1.1.1. Liquidity

Managing liquidity by either temporarily delaying the payment of expenses or holding back the cash on behalf of others.

1.1.2. Profitability

Showing higher or lower level of profits by changing accounting policies.

1.1.3. Earning Management

Influencing the earning for the period by employing creative methods of accounting is termed earning management whereas playing around the accounting policies and procedures to project a desired level of earning for equity shareholders is termed as fraudulent mechanism of earning management. Earning management involves artificial increase or decrease of revenue, profits or earning potential of assets, this is done with the help of aggressive accounting tactics. Aggressive accounting involves misstatement of financial statements-balance sheet and profit and loss account with the goal of presenting economic stability of the business firm. Certain aggressive accounting techniques are legal as these are performed within the flexibility granted by accounting standards and few cross the limits and identified as illegal practices. Aggressive accounting is also called window dressing or creative accounting.

1.1.4. Management of Assets and Liabilities

Management of assets and liabilities implies skillful presentation of different assets and liabilities by either using flexibility provided by accounting standards or by the violation of accounting practices to achieve desired level of assets and liabilities.

1.2. Why Creative Accounting?

There are several reasons for using creative accounting leading to window dressing of accounts. For example:

a). To keep the company's financial results within agreed limits specified by owners.
b). To help raise further capital at a favorable price.
c). To fulfill public listing requirements.
d). To help negotiations with regulators or with the acquirer in case of merger.
e). To pay less tax.
f). To push the company towards insolvency or to delay the insolvency.
g). To hide inefficiencies of managerial team.
h). To smooth out income.

1.3. Creative Accounting Techniques

Creative accounting can be applied by using all or any one of the tools discussed below depending upon the objective of using it.

1.3.1. Creating Multiple Trading Entities

Under this a large business house dealing in multiple products and multiple consumer segments creates a separate trading entity to whom goods and services are sold for executing sales to end users. This process helps in creating same amount of profit in two different trenches and helps in avoiding tax, which otherwise would have been paid.

1.3.2. Moving Business Segments Offshore

Sometimes business entities create offshore business outfit to carry out its foreign business. These offshore business outfits are not subject to the accounting and disclosure norms of the home country, therefore companies can hide the actual level of profit or loss which should have been reflected in the annual accounts of the company had the offshore business segment not been created.

Enron limited managed to hide the losses by executing this creative accounting technique. It could hide the losses resulting from certain business segments by passing the transactions to offshore outfits. The shareholders and regulators could not come to know the losses from such offshore business segments as these were not reflected in the annual accounts of Enron limited.

1.3.3. Changing Inventory Valuation

Inventory is one of the assets that are very much sensitive towards the changing market prices. In certain industries price of inventory changes several times in a day, like edible oil, crude oil, gold, silver, certain commodities and so on. This changing price of inventory can be used as a tool for window dressing of accounts. By changing inventory valuation practices companies can influence (i) cost of goods sold, and (ii) value of closing inventory disclosed as current asset in the balance sheet.

During the inflationary period when prices have increased from point to point time basis the change from LIFO method to FIFO method of inventory valuation will deflate the cost of goods sold and inflate the value of inventory shown as closing stock in the balance sheet resulting into inflated profit. Similarly, during the period of recession a change from FIFO to LIFO will result into an inflated cost of goods sold and deflated value of inventory reported in the balance sheet.

1.3.4. Changing Depreciation Policy

Depreciation is a non-cash expense resulting from an accounting entry which has twin effect i.e. it records a reduction in the book value of the asset being depreciated at the same time total cost of goods sold also gets affected. A change in depreciation method from straight line method (SLM) to written down value (WDV) will surely have an impact on the profit and the level of assets reported in the balance sheet.

Normally a change from SLM to WDV will result into comparatively lower amount of depreciation resulting into an increased profit and increased book value of assets. Similarly, a change from WDV to SLM will result into comparatively higher amount of depreciation resulting into a decreased profit and increased book value of assets.

1.3.5. Deviation in Revenue Recognition Practices

The most common practice of creative accounting leading to window dressing of financial statements is deviation from standard revenue recognition practices. As per the accounting principles of "revenue recognition" revenue is to be recognized at the time when sales has been executed and claim of the selling company is justified against the buyer and not at the time when order is received or goods are being processed/manufactured. Any deviation from this standard/principle will certainly have increased level of revenue.

1.3.6. Deviation in Matching Concept

Principle of matching concept stipulates that all the relevant expenses should be recorded in the books of accounts so as to arrive at the accurate amount of profit. This not only helps in reporting the profit at accurate level but also helps in an accurate measurement and presentation of assets and liabilities.

A deviation in matching concept can help manager to report desired level of profit. To show a higher level of profit, certain expenses like outstanding expenses, non-cash expenses-depreciation or amortization of intangible and fictitious assets is deferred temporarily resulting into lower total cost and higher level of profits. The same is reversed in the beginning of next year. This practice helps in reporting a higher level of profit which helps in judging the performance of management as good performance with an improvement.

Similarly, when company wants to report lower level of profit and have tax evasion it can show extra expenses that are not otherwise relevant for the current financial year rather relate to next financial year.

1.3.7. Change in Recognition of Assets

Accounting standards stipulate the guidelines for the recognition of assets as current, fixed, intangible and fictitious assets. However, there exists certain flexibility in recognizing these assets. Using this flexibility one can influence the value as well as classification of assets. Most sensitive assets are investments that may be classified as "held for sale" or "held to maturity". This classification is subject to the perception and vision of management affected by market sentiments. An interchange in these categories can affect the valuation of assets and recognition of profit and loss on such assets.

II. REVIEW OF LITERATURE

Review of literature of different studies reveal that adoption of creative accounting to achieve desired financial performance is inspired by top management. Different studies revealed the following facts:

Foster (1984) stated that the difference in individual's level of perception and degree of reliability of information disclosed in the financial statements are likely to influence the process of decision making by the users of financial statements. Usually users of financial statements have more faith and trust on audited financial statements as compared to unaudited financial statements. A set of audited financial statements creates an aura of faith and trust.

Stueart et al. (1993) showed that creative accounting first became very prevalent in the 1980. Due to loopholes of accounting regulations, companies could produce accounts which flattered their financial performance. It talks about type of creative accounting like capitalizing interest, brand accounting, methods of depreciation, stock valuation, and accounting standards which prevent the major abuses which used to occur and has issued a number of regulations in the form of Financial Reporting Standards.

Hussey and Ong (1996) stated that much is written about Creative accounting and about the various schemes of window dressing and off-balance sheet financing and very little information is available how widely such schemes are used by various companies. Because of much concern topic about creative accounting, it was difficult to obtain data from companies about their own creative accounting practices. However, it was felt by researchers that external auditors ought to represent an alternative source of creative accounting providing that their client information will keep secret.

Elisabeta and Beattrice (2010) stated that has done short review of creative accounting topics and its development to know about what are the motivations for creative accounting literature and solution to this creative accounting term. They tried to correlate creative accounting with different interest area like bankruptcies, audit, governance, financial market, the public sector and quality of financial reporting to prevent creative accounting by taking various articles from scientific data sources

Matiş et al. (2010) showed that tried to explain the topic of creative accounting and corporate governance in the context of internal demand for manipulative behavior which emanates from the contracting value of earning management in the principal-agent relationship between shareholders and mangers poor corporate governance causes manipulating accounting practices.

III. CREATIVE ACCOUNTING-REAL LIFE EVIDENCES FROM INDIA AND USA

There have been many incidences of adopting creative accounting leading to window dressing of financial statement in Indian corporate sector. In practice small cases of window dressing are like "golden fish" and remain under the water and do not get noticed till the time they become as large as a "whale". The moment these get noticed and catch the eyes of regulators and media these are reported as scams. Recently the story of financial Scam of Satyam computers services limited is similar to this. The same was the story of Enron limited of USA.

3.1. Satyam Computer Services Limited, India-Story of SCAM

Satyam computer services limited one of the leading India outsourcing company ranking fourth in terms of software services was put to lime-light by the resignation of its founder and chairman Mr. B. Ramalinga Raju (Raju). This sent a negative wave to Indian stock market and price of Satyam computer services limited (Satyam) tumbled by about 85% in one trading session. Satyam served as backbone of many banks, corporate houses, health care services, insurance companies not only in India but across the globe. Just before the scam was unearthed Satyam's employee roll revealed that around 50,000 people were employed in Satyam and US GAAP statement of Satyam as on 31st March, 2008 disclosed a bank deposit of Rs. 3,400 crores which vanished in the beginning of the next financial year. It raises an eyebrow on the role of statutory auditor Price Waterhouse Corporation (PWC). What as an auditor they were doing? Why didn't they verify the balance with the banker?

Was this money siphoned away to some of its subsidiaries like Maytas infrastructure limited or used for the personal purpose of the directors or chairman. Even after knowing all these facts NASSCOM did not accept the plan to disqualify Satyam as a member but it assured to work with Satyam and its employees (numbering to about 50,000 employees) to manage the situation.

3.1.1. Confession by Mr. Raju

The facts about the falsification of accounting facts at Satyam were admitted by its head Mr. Raju in a self declaration type letter leading to the confession of crime. Crime in the sense a small level creative accounting resulted in the accumulation of false profits, false assets, and unlawful presentation of liabilities over the years. The abstracts of Mr. Raju's letter are as follows.

The balance sheet as on 30th September, 2008 carried following window dressing items:

a). Inflated amount of interest by Rs. 376 crore, this was inflated by showing accrued interest which really did not exist.

b). Understatement of liability to the tune of Rs. 1,230 crore on account of funds arranged by Mr. Raju.

c). Refined position of debtors by about Rs. 490 crore as against Rs. 2,651 crore in the books.

d). For the second quarter ending September, 2008 company reported a revenue of Rs. 2,700 crore (actual Rs. 2,112 crore) and an operating profit margin of Rs. 649 crore (actual Rs. 61 crore) by showing operating profit margin of 24% as against an actual of 3%.

e). Artificial inflating of revenue and operating profit resulted into an increase in the cash balance by Rs. 588 crore in the second quarter alone.

The gap between reported revenue, profits, assets and liabilities and actual figures of these was supported by showing artificial figures of employees, carrying additional assets and related activities this all resulted in an increase in profit margins.

3.1.2. Why Mr. Raju Confessed?

The reason, why Mr. Raju confessed about the fraud and admitted having the knowledge of the same, may be because the promoters had very little percentage of shareholding in the company. They were apprehensive of a probable take over by the rival companies. However before the confession Mr. Raju made a last attempt to buy one of its subsidiary namely Maytas infrastructure limited but the deal failed and Mr. Raju found himself in a soup and thought that it was not possible to either come out of the red or avoid probable takeover due to very thin equity stake of promoters and he willfully confessed.

3.2. Enron Corporation Scandal-Story of SCAM

Accounting scandal of Enron was revealed in October 2001 leading to the bankruptcy of Enron corporation and dissolution of one of the auditors of Enron namely Arther Andersen. Story of Enron scam is not only the biggest scam in the corporate world of USA but also a biggest question mark on the accounting and auditing regulation in the country like America.

3.2.1. Foundation and Beginning

Enron limited (Enron) was founded by Kenneth Lay in the year 1985 by merging Natural Gas Pipeline Companies of Houston Natural Gas and Inter North. Initially the business profile of Enron was to generate electricity and sell it at the market price. Enron also engaged in lobbying to persuade government of America to have free market system for pricing electricity and it succeeded too in doing so. By the year 1992 Enron succeeded in becoming largest seller of electricity in North America and majority of its revenue was attributed to gas contract trading segment. In the year 1999 company managed to start Enron online trading website which helped it to manage its trading business much more efficiently.

3.2.2. Diversification

Influenced with the success in online trading business Enron pursued a modernization and diversification strategy and company owned variety of assets like gas pipelines, pulp and paper plants, water plants, electricity plants, broadband services not only in America but across the globe as well. The tricky idea of generating business was to enter into self generated contracts and creating derivatives (derivatives are the contracts which derive value from an underlying asset) on these contracts.

The impact of all this was that the stock of Enron recorded a rise of about 300% from 1990 to 1998. The stock of Enron further recorded a rise of about 55% in the year 1999 and 85% in the year 2000 as compared to a corresponding decline in the index by 20% and 10% respectively. By the end of December, 2000 price of Enron's stock was $82 plus with a market capitalization of $60 billion plus. Enron was also ranked as most innovative company of America.

3.2.3. Causes of Downfall-Creative Accounting for Earning Management

There were several reasons for the Enron's debacle, Enron adopted mechanism of creative accounting leading to world's largest accounting scandal. The scrutiny of books of accounts reveals the following creative accounting techniques used by Enron.

3.2.4. Revenue Recognition

Enron was engaged in building and maintaining electric power plants, natural gas pipelines and related processing facilities. Apart from it Enron engaged in the trading of electricity. As Enron involved in trading of electricity as an agent but it adopted "merchant model" to account for the business transactions relating to trading business conducted as an agent. Whereas, it should have adopted "agent model" of accounting for trading business transactions.

Agent Model vs. Merchant Model for Trading Business

Agent model of accounting for trading business is to be adopted when the business entity facilitates the task of an agent. Accordingly, an agent should recognize the commission or brokerage as its revenue and matching expenses should be the one incurred in earning the brokerage.

Merchant model of accounting for trading business is to be adopted when the business entity itself is one of the parties to trade as buyer and subsequently the goods/services purchased are sold at a margin. This model stipulates the recognition of revenue at the gross selling price of goods and services and the cost of goods sold is to be recognized as matching cost for the revenue recognized under the model.

Here intentionally merchant model of accounting was adopted instead of agent model leading to higher amount of revenue and profit as compared to the actual amount of revenue and profit. Enron recognized full value of the deal as revenue and corresponding cost of the electricity sold as cost of goods sold. This resulted in reporting total amount of gain as if it belonged to Enron as compared to it the actual earning was only the brokerage relating to the deal.

By departing from agent model to merchant model Enron could report artificially higher level of revenue and profits year after year. With the help of this, Enron reported an increase in its revenue by about 740% during the period from 1996 to 2000 rising from $13 billion in 1996 to $98 billion in 200. Resulting into an annualized growth rate of about 100% plus as compared to an average growth rate of about 5% in electricity industry.

3.2.5. Long Term Contracts and Fair Value Approach

Fair value approach of accounting for long term contracts stipulate that the expected gains from such contracts and cost of these contracts should be recognized at the present value of estimated revenue and cost to generate such revenue under contract. The difference between these two is to be recognized as revenue for the current period. Enron adopted this practice for recognizing its long term contracts for electricity trading, gas pipeline business and others.

The biggest pitfall of this approach is faced when a long term contract has a premature termination resulting into de-recognition of assets, liabilities, expenses and revenue relating to terminated long term contract. But Enron continued to shown the contracts and related revenue in its books of account even when contracts had been terminated. One such contract was signed between Enron and Blockbuster Video in July 2000 for a period of 20 years agreement. As per the agreement Enron was to provide the service over the agreed period and estimated a profit of $110 million form this single deal. Enron reported this as income at its present value by using fair value approach. When subsequently deal failed even then Enron continued to recognize this income in its accounts.

3.2.6. Special Purpose Entities

Enron created certain special purpose entities to circumvent business transaction and hide the debt component actually used by it. The financial position of special purpose entities like assets, liabilities, costs and revenue of these entities are not disclosed in the financial statements of sponsor. This fact helped Enron to hide the debt and loss generating transactions by routing through these hundreds of special purpose entities created by Enron.

3.2.7. Snowball

Financial accountant of Enron started the practice of recognizing the cost of cancelled projects and contracts as an asset rather than recognizing it as a loss in the profit and loss account. This resulted in inflating profits as well as assets. The assets and profits so created and know as "the snowball" that are likely to melt any day resulting into a loss and decline in the assets. The scrutiny of Enron's books of accounts revealed a volume of such snowball to the tune of $200 million.

3.2.8. Creation of on its Own without Market Testing

Enron was having its own electricity generating units and trading business to buy and sell the electricity also. Enron entered into long term contracts as long as 20 years for buying and selling electricity as an agent and reported present value of the expected profit as profit in one single quarter as compared to spreading it to future years. At the same time the estimates of revenue and costs for these long-term contracts were not put to test in the market with respect to accuracy in estimation.

3.2.9. Executive Compensation

To keep its executives motivated to perform better Enron paid not even good remuneration to its executives but also awarded them with stock options. Executives were interested in finalizing the business deals which had positive impact on the stock prices without considering the quality of cash flow and timing of profit from such deals. The sole motive of the executives was to have gain from exercising the stock options when price of Enron's stock rises on account of rising revenue and profits. As on 31st December, 2000 Enron had about 95 billion shares outstanding under stock option plan which was approximately 13% of the ordinary shares outstanding.

3.2.10. The Clue that Led to the Unearthing of Scam-Credit Rating Downgrade

The first symptom of Enron's debacle was downgrading of credit rating by Moody's and Fitch in October, 2001. The impact of downgrade was severe enough which forced Enron to plan to issue enough number of shares to cover the debt instruments issued by it. This downgrading of credit rating force the counter parties to review their long term contracts with Enron and few of the parties even cancelled the contracts. This resulted into a heavy loss not only during the year 2001 but also for the coming years too. The cancellation of contracts resulted into liquidity problem for Enron and further downgrading in the credit rating to Baaa2 just two points above "junk rating symbol". This created a further liquidity problem and increased number of cancellation of long term electricity trading contracts. Which eventually eroded revenue, profits and assets of Enron. At the same time the liabilities which were understated due to the circumventing of transactions through special purpose vehicles were exposes and liabilities also mounted by the end of 2001.

3.2.11. Negative Outcome

As soon as the story of Enron was exposed the share prices of Enron tumbled to as low as $1 from a high level of $83 plus. This resulted into a heavy loss for general investors as well as employees who were holding stock options received as reward for their service rendered to company. At the same time suppliers, debenture holders and money lenders suffered a heavy loss. Enron was declared bankrupt at the same time one out of its five auditors Arther Anderson were dissolved.

IV. CONCLUSION

Someone has said it rightly that "accounting is science and art both". As it is based on certain time tested universally applicable fundamentals like International Financial Reporting Standards (IFRS) leaving no room for misrepresentation therefore we can say it is science. It is an art because the presentation of books of accounts within the boundaries of accounting standards needs an artful work.

When the art of presenting financial results is presented beyond the permissible limits it results into accounting scandals like that of Enron in USA and Satyam in India. These accounting scams and scandals certainly benefit the insiders to a great extent but always have a negative outcome for the poor investors who trust the published annual accounts-annual report of companies. The history of accounting scandals reveals that even audited books of accounts can not be taken at their face value. In this era of rising number of accounting scandals we do not need auditors but we need forensic accountant like KAUTILYA of ancient India having skills to smell the scam and blow the whistle in time to alert the investors.

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