

Vol 4 Issue 3 Dec 2014

ISSN No : 2249-894X

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*Monthly Multidisciplinary  
Research Journal*

*Review Of  
Research Journal*

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RNI MAHMUL/2011/38595

ISSN No.2249-894X

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## IMPACT OF CREATIVE ACCOUNTING IN THE FINANCIAL REPORTING FRAMEWORK: A STUDY IN THE INDIAN CONTEXT

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### Abstract:

*Underscoring the need to emphasize the role played by the camouflaged financial statements, particularly in the context of decision making; this paper discusses the need to have a systematic approach towards dealing with the new branch of accounting, i.e. creative accounting. Evidently, organizations across the horizons have witnessed some major set-backs during the recent years, and the reasons for all such debacles have given birth to creating accounting. The paper also highlights the impact of creative accounting in the financial reporting framework, particularly with regard to the Indian Companies. The various pitfalls of this new branch of accounting, as pointed out by critics has been thoroughly assessed and investigated. The paper also recommends a thorough investigation of financial statements with proper documentary evidence in order to avoid creative accounting and the necessary repercussions thereof.*

### KEYWORDS:

Creative Accounting, Financial Statements, Liquidity Ratios, Profitability Ratios .

### INTRODUCTION

The world has witnessed a plethora of financial debacles in the last two decades. Financial scams seem to be at a forefront even after having sound national and international regulatory bodies to check the functioning of the financial institutions. The notion that the financial markets are self-regulating seems slightly quaint now. Unless a proper remedy is discovered to control the functioning of the systems, it would become difficult to manage the multitude of financial institutions, thereby ensuring sound and ethical governance of the system. On thorough investigation of all the scams that has been witnessed by the global world, a new technique of accounting has come to the picture. This new technique or new branch of accounting has been defined as Creative accounting. Creative accounting in a layman language means using the creativity of an accountant or a manager to manipulate the financial statements to the benefit of their own business enterprise. 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 excessive compliance and the use of novel ways of characterizing income, assets, or liabilities and the intent to influence readers towards the interpretations of desired results.

Creative accounting is a double edged sword, if it is used correctly it can give great benefit to user; but if it is mishandled or goes in the hand of wrong person, it can cause much harm. Creative accounting has

Title: "IMPACT OF CREATIVE ACCOUNTING IN THE FINANCIAL REPORTING FRAMEWORK: A STUDY IN THE INDIAN CONTEXT" , Source: Review of Research [2249-894X] Rajan Gehlot<sup>1</sup>, Sameer Lama<sup>2</sup> and Chetan Yadav<sup>3</sup> yr:2014 | vol:4 | iss:3

helped more companies to get out of a crisis than land them into crisis. Creative accounting is root cause of number of accounting scandals and many proposals for accounting reform are focusing on removing such practices. Financial statement is the result of the financial accounting process that accumulates analyses records, classifies, summarizes, verifies, reports, and interprets the financial data of a business firm, which reflect the financial position, performance and change in financial position of an enterprise (Elliott, 2005). 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.

### 1.2 Objectives of the study

1. To examine the impact of creative accounting in financial reporting framework.
2. To analyse the repercussions of creative scandals among the Indian firms.
3. To assess the existing literature in the domain of creative accounting.

### 1.3 Review of Literature

Various studies have documented the intriguing aspects of creative accounting across the world. Many studies have highlighted on the challenges and the different methods of creative accounting that have been witnessed during the last two decades. In totality a detail investigation of the review of literature on creative accounting suggests that a cryptic metaphysics is involved in the financial statement of the business enterprises. The deceptive financial statements, in order to give a rosy look to the various users of accounting information leads to creative accounting, specific finding of the study reveals the following:

Littrell (1980) reveals that cost allocation between product lines and transfer prices between subsidiaries, rarely becomes a matter of public records which encourages creative accounting. Naser (1992) highlights that various schemes of window dressing and off-balance sheet financing and which are used by various companies. The author examines on findings the relationship whether creative accounting practices of companies or industrial classifications, the reasons behind the use of creative accounting, perceived legitimacy, consequences of the continued use of creative accounting, and measures to be taken to minimize its use. It was observed that external auditors ought to represent an alternative source of creative accounting practices. Hussey & Ong (1996) underscores that creative accounting became prevalent in the 1980s, due to loopholes of accounting regulations; companies could produce accounts which flattered their financial performance.

Blake & Salas (1996) explained that creative accounting is seen as widespread in the U.K. during 1990s, the problem was observed in Spain within the Continental European model of accounted regulations. Smith (1998) revealed the accounting manipulations employed by 208 of the largest quoted UK companies and identified 12 different techniques in the common use, all of which would impact on the Profit and Loss account and Balance Sheet of the companies concerned. Shah (1996) examined the process of creative compliance in case of complex convertible securities issued by U.K.

Healy & Whalen (1999) highlighted how standard setters should decide or make accounting standards to reduce the possibility of earnings management. Information about the company is provided by the financial reporting which show the true and fair view of company but managers should manipulate the financial numbers than actual due to their personnel interest like to increase their management compensation, to provide low salary to employees, to pay fewer dividends to the shareholders. Amat, Blake and Dowd's (1999) reveal that Creative accounting provides an opportunity to companies to manipulate things in desired manner. Moreover, Government or concerned authorities have taken adequate steps to protect companies from such practices but there are many users of financial statements who are not aware about creative accounting or earnings management and thus management gets chance to mould the books in the way they want. Herve & Gaetano (2004) throws lights upon the reasons and objectives of accounting manipulations. The author highlights that the accounting manipulations is agency cost and difference in opinion & objectives between managers and owners. Owners believe in sustainability and long term profitability of the company but manager's objective differ in terms of getting extra profits from the firm. Some studies have been conducted in the Indian context during the recent years on creative accounting which reveals that Indian market was never dominant by any developed economy as the number of investors and wide market always force market of many economies to move in the way participants want. But from few years, the confidence of investors from the market has been lifted which pushes participants to withdraw their money and find other way of investing. Through the study it has been observed that alternative choices available in accounting system and flexibilities provided in the accounting standards are major reason of accounting manipulations.

Rabin (2005) examined the ethical behaviour and attitude of auditors. Auditor's ethical judgment is formed by the provisions of the code, organizational policies governing ethics and individuals own moral agency. Ethical judgment is fundamental to auditors in forming opinion whether financial statement fairly present the financial position, result of operations and cash flows of an entity and it is distinct from compliance with statements of GAAP. Vladu & Mati (2010) highlighted the role of creative accounting and corporate governance in the context of internal demand for manipulative behaviour. The author revealed that manipulative behaviour which emanates from the contracting value of earning management in the principal-agent relationship between shareholders and managers, poor corporate governance causes manipulating accounting practices. Moldovan, Achim & Avram (2010) focused on how information provided by accounting affects external users, and mainly on how and why distorted information gets outside of the organisation into the hands of unsuspecting users. The author explained that there is an inverse causal relationship between true and fair view principal and creative accounting.

Schipper (1989) observes that "creative accounting" can be equated with "disclosure management", the sense of a purposeful intervention in the financial reporting Process". The author also reveals that 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. Zhah, Butt, & Tariq, (2011) tried to explain why managers resort to creative accounting and how they become successful in performing such practices in the presence of stringent rules and procedures. They also tried to explore whether creative accounting practice is good or bring crisis in the companies and link of corporate governance with creative accounting.

Mati, Vladu & Cuzdriorean (2012) highlighted the creative disclosure in corporate annual report under forms of distortion of narratives of numerical and graph manipulation. They gave importance to theoretical framework than empirical study because interpretation of empirical analysis is impossible without theoretical guidance. Creative presentation must be regarded as a complex mechanism that includes motives for engaging in manipulation of accounts, types of information disclosed and types of manipulation strictly connected to presentation of information.

#### 1.4 Methods & Techniques of Creative Accounting

The following are some of the common creative accounting methods and techniques followed by companies which give us an idea to focus on the regulatory mechanism:

1. Amortization of Expenditure: Companies resort to take undue advantage with regard to the amortization of expenditure over the useful life of asset /project. This tends to deflate the profit which leads to Creative Accounting.
2. Depreciation of Fixed Assets: The expected life of the fixed asset of a Company is mainly ascertained by the managers of a concerned department and hence the scrap value and realization value of such asset is predefined by the manager. The valuation of depreciation and the usage of assets generally tend to favour the management in terms of profit calculation and giving a rosy look to the different users of the information. This process facilitates Creative Accounting.
3. Sale and Lease Transactions: In case of sale and lease back transactions, where third party is involved such as bank, the chances of creative accounting are more. While giving example, Naser stated that, 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.
4. Differential Tax Scenario: MNCs operating in different countries of the world takes the loopholes of tax differentiation of one country over another country which gives rise to Creative Accounting. Companies are free to decide transfer pricing method and thus high transfer price can be applied in high tax regime units. Such alternatives are important example of creative accounting.
6. Availability of Various Options as per Regulatory Authorities: Accounting regulation often permits a choice of policy, for example, in respect of asset valuation (International Accounting Standards permit a choice between carrying non - current assets at either revalued amounts or depreciated historical cost). Business entities may quite validly change their accounting policies. Sometimes, the change in the policy or method is in contrast to the standards and the will of the investors. Companies tend to reflect a good picture which the actual picture may not be true. This again facilitates Creative Accounting.

#### 1.5 Importance of proposed research work

When any financial fraud comes into picture, we usually tend to blame the system and regulatory

bodies and forget the role of investors in motivating corporate sector to enter into such practices. Through the present study we try to focus on role of investors in motivating companies to get an undue advantage. Lack of knowledge and understanding of financial aspects of any business leads to wrong decision of investment. Decisions by companies to engage in off-balance sheet financing or to capitalize expenditures that should be written off have resulted in serious financial repercussions for the involved companies, for investors, and for the economy as a whole. Since the stock market crash in the early 20th century, the ethics of managers and executives have been called into question.

**1.6 Data and Research Methodology**

The current study is based on secondary data. Various information pertaining to the study has been derived from journals, e-databases and books available in Ratan Tata Libraray of the University of Delhi. Data has also been derived from the website of money control; India’s no 1 financial portal (www.moneycontrol.com) which provides information about various parameters of the companies operating in India. The relevant data has been sorted as per the objectives of the study and thereafter thoroughly examined to come up with a valid set of findings of the study. The analysis has been done using the index of the financial indicators of liquidity and profitability.

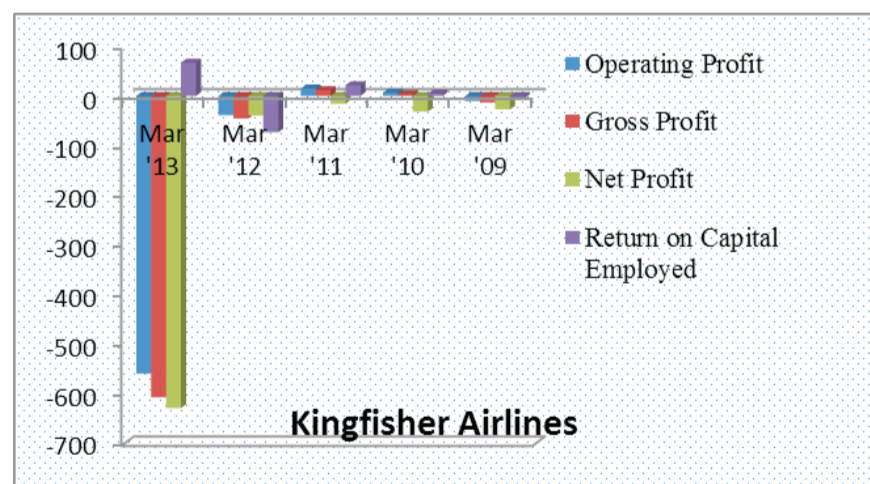
**1.7 Analysis of Data**

The financial statements of three major Indian Companies have been taken for the study. Financial statements primarily showing the liquidity and profitability index for the preceding five years have been taken in order to examine the impact of any fraudulent practices in the corporate house. The increase or decrease in the profitability or the liquidity index clearly brings forward the new concept in accounting termed as creative accounting. The following table provides the profitability and liquidity index:

**Table 1: Profitability Index-Kingfisher Airlines  
(In crores)**

	Mar '13	Mar '12	Mar '11	Mar '10	Mar '09
Operating Profit	-560.1	-39.29	15.14	6.32	-10.49
Gross Profit	-607.72	-45.51	11.88	3.1	-13.02
Net Profit	-629.31	-39.97	-15.99	-32.04	-27.43
Return on Capital Employed	67.21	-73.61	21.72	4.35	-3.68

**Fig. 1**

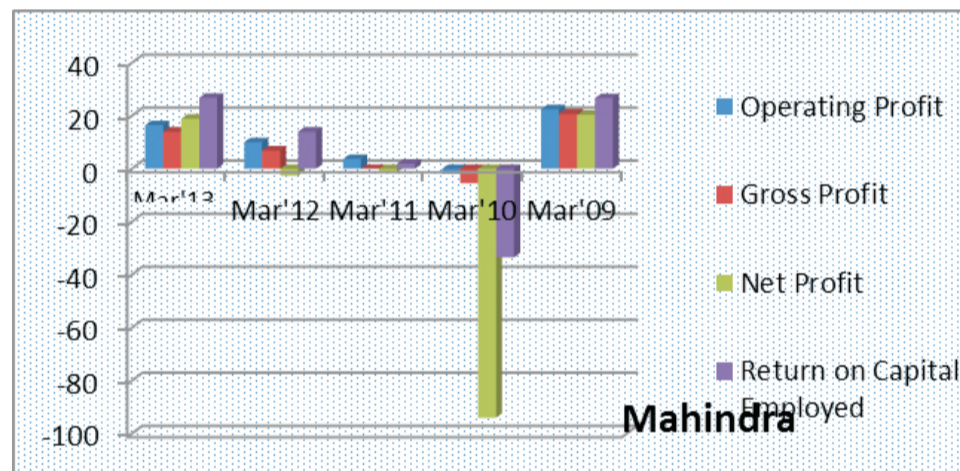


The profitability index as depicted in the above table clearly validates our hypothesis. The profitability index of kingfisher airlines as per (Table 1) shows an adverse scenario particularly during 2012-2013. This is supported by evidences which validate our claims that the implications of the deceptive financial statements have negative repercussions particularly in the profitability index of the company. The net profit/loss of king fisher airlines as shown by the Table 1 is - 629.31 crore. This figures reveals that king fisher airlines had the maximum amount of deficit during 2012-2013, if we compare the index for the preceding 5 years. Most of the index, i.e. gross profit, net profit are having negative balance, however return on capital employed still remains positive with 67.20 crore and this may be the reason that king fisher airlines still enjoys some creditors among investors.

**Table 2: Profitability Index of Mahindra Satyam (In crores)**

Mar'13	Mar'12	Mar'11	Mar'10	Mar'09
Operating Profit	16.52	10.04	3.74	-1.95
Gross Profit	14.02	6.91	--	-5.47
Net Profit	18.92	-2.58	-1.37	-93.98
Return on Capital Employed	26.84	14.01	1.94	-33.45

**Fig. 2**

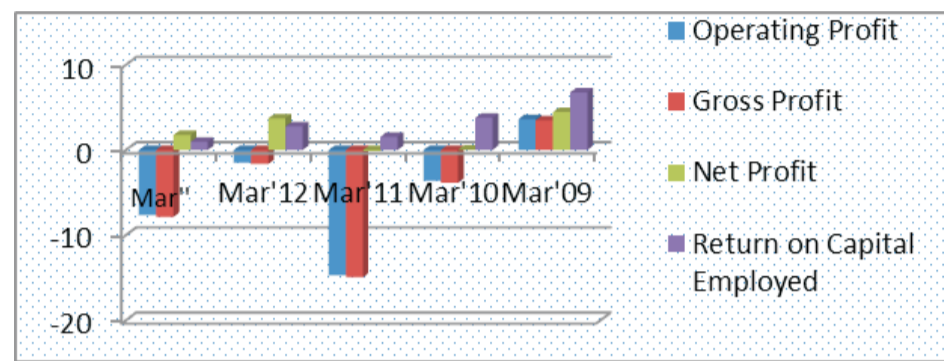


Similarly Profitability index of Satyam shows significant improvements during the financial year 2012-2013, net profit of company showed a balance of 18.92 crore and the return on capital employed at 26.84 crore which is the highest margin. If same figure is compared for the preceding five years, however company's performance was at deplorable condition during the year 2009-10. The net loss during the financial year 2009 stood at 93.98 crore which validates our hypothesis that creative accounting have a negative impact on Profitability index of the companies.

**Table 3: Profitability Index of Sahara One Media Entertainment (In crores)**

Mar'13	Mar'12	Mar'11	Mar'10	Mar'09
Operating Profit	-7.65	-1.49	-14.73	-3.63
Gross Profit	-7.87	-1.66	-14.94	-3.86
Net Profit	1.75	3.71	-0.16	0.03
Return on Capital Employed	0.96	2.76	1.55	3.78

Fig. 3



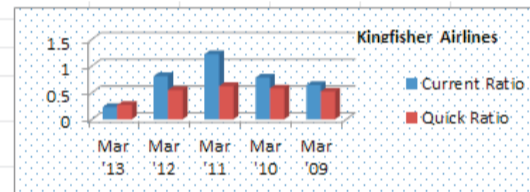
Similarly, Profitability index of Sahara One Limited have significantly decreased during last financial year, 2012-13 (Table 3). This proves that whenever the company resorts to any malaise intentions and tries to decline the different stakeholders, associated with company, the company's profitability and liquidity position gets negatively impacted.

**Liquidity Ratios of Kingfisher Airlines**

Table 4

	Mar '13	Mar '12	Mar '11	Mar '10	Mar '09
Current Ratio	0.23	0.81	1.22	0.78	0.64
Quick Ratio	0.27	0.55	0.62	0.58	0.52

Fig. 4



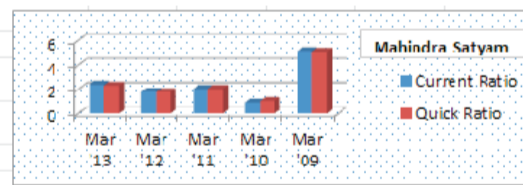
The thorough investigation on the data available for financial statements for the preceding 5years also reveals the comparatively kingfisher airlines had a very low liquid assets or current assets during financial year 2013, this is one of the major challenge which kingfisher airlines is facing currently. The absence of sound current balance has deteriorated the credibility of king fisher airlines in the industry over a couple a years, evidences also suggest s that king fisher airlines has not been able to pay the salaries of employees due to low liquidity ratios.

**Liquidity Ratios of Satyam**

Table 5

	Mar '13	Mar '12	Mar '11	Mar '10	Mar '09
Current Ratio	2.37	1.8	2.04	0.93	5.15
Quick Ratio	2.3	1.78	2.04	1.05	5.09

Fig. 5



However, the current ratio (2.37) and quick ratio (2.30) of Mahindra sat yam as per Table 5, is significant as per rule of thumb. That means Mahindra Satyam still enjoys a good amount of current assets to meet its current obligations, this can be one of the reasons why irrespective of negative profitability index of Mahindra Satyam it still enjoys positive index for the return on capital employed (Table 5). Both liquidity ratio (current ratio and quick ratio) i.e. current ratios (0.23) and quick ratios (0.27) are below the generally accepted norms or rule of thumb of companies.

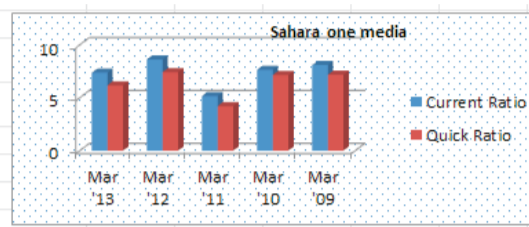
**Liquidity Ratios of Sahara One**



**Table 6**

	Mar '13	Mar '12	Mar '11	Mar '10	Mar '09
Current Ratio	7.35	8.62	5.16	7.63	8.08
Quick Ratio	6.17	7.41	4.21	7.13	7.16

**Fig. 6**



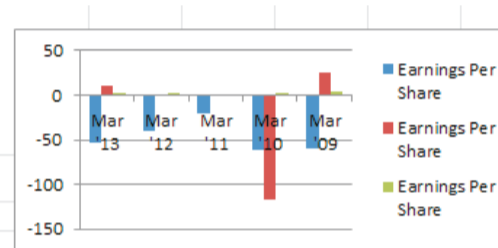
However Table 6 reflects a very different picture in terms of liquidity ratios of Sahara One in spite of having a low and adverse profitability index, the current ratio i.e. relationships between current assets and current liabilities stands at 7.35 (Table 6) and the quick ratio i.e. the relationship between liquid assets and current liabilities shows a ratio of 6.17 (Table 6).

**Earnings per share**

**Table 7**

King fisher , Satyam and Sahara	Mar '13	Mar '12	Mar '11	Mar '10	Mar '09
Earnings Per Share	-53.18	-40.3	-20.64	-61.95	-60.5
Earnings Per Share	10.22	-1.08	-0.61	-117.75	25.59
Earnings Per Share	0.83	2.46	-0.1	0.02	4.15

**Fig. 7**



Earnings per share of Kingfisher airlines (Row 1, Table 7) is consistently showing decreasing trend since last five years due to financial crisis of company. Similarly Satyam (Row 2, Table 7) was facing similar situation but sharp recovered in 2013 after Mahindra has taken over it. Sahara group (Row 3, Table 7) is also getting very low returns and would not be able maintain its operation.

**1.8 FINDINGS OF THE STUDY**

- ❖ Window dressing of financial statements leads to an adverse implications on the overall performance of the company.
- ❖ All profitability index of the king fisher airlines (Table 1) of the study shows a negative balance except on return of capital employed, which suggests that indulging in malaise practices or creative accounting severely affects the overall financial statements of the organisation.
- ❖ Profitability index of Mahindra Satyam for the financial year (2009-10) shows a negative balance (Table 2). This again proves that Satyam debacle (2009) was moreover a result of creative accounting which had a very negative impact on the overall performance of the firm.
- ❖ Again, the profitability index of Sahara One Limited for the financial year 2013-14, also had the negative result (Table 3). This again proves our hypothesis that whenever there is any false representation of financial information it leads to some major financial debacles in the forthcoming years.
- ❖ The current assets and quick assets of Kingfisher airlines were highly insignificant during the financial year 2012-2013. Their failure to maintain current assets and liquid assets diminished the credibility of the airlines during recent times. This fact manifolds with the news of some employees who committed suicide as the airlines was unable to pay salaries to many employees for over six months.
- ❖ The liquidity ratio of Sahara however shows a position balance for the financial year 2013 which gives the management a good chance to bounce back during the forthcoming years.
- ❖ Kingfisher airlines have a worst ratio in terms of earning per share (Table 7). The inability to maintain the liquid and current assets by the company and supposedly, the negative publicity of the airlines in the industry has resulted to a low market capitalization and earning per share of the company.

## 1.9 RECOMMENDATIONS

On the basis of this study, the following recommendations are put forward. The recommendation is expected to provide a panacea to the plethora of problems as detected in the study. In general, we recommend the following two important recommendations:

- Companies need to abide by the principles and the standards as prescribed by the national and international accounting standard boards.
- The practice of indulging in any fraudulent activities should be strictly prohibited by the management. Window dressing of financial statements should not be given any scope for the credibility and longevity of the companies.

### **In particular, the following are the recommendations of the study:**

Companies, particularly Kingfisher Airlines and Sahara One are required to keep a track on the profitability ratios. Both the companies are required to minimize their operating and non-operating expenses and maximize the turnover and sales revenue in order to be in a stable position.

- ❖ Mahindra Satyam has a tremendous growth prospects for the forthcoming period. However, the company is required to focus on the new initiatives and the demand of the customers to continue its present level of profits.
- ❖ Kingfisher Airlines have failed to manage the liquid and the current assets. However, Mahindra Satyam and Sahara One are having a better margin than Kingfisher Airlines in this regard. Hence, the Kingfisher Airlines should take immediate measures to have more liquid funds to manage the operating activities of the company.
- ❖ The earning per share of Kingfisher Airlines and Sahara One doesn't reflect a good position during the recent years. Both companies are required to restructure the investment and financing norms in the market and hence improve the goodwill and credibility in the market, which would help the companies to improve the earning per share of the companies.
- ❖ All companies should take necessary precautions to not resort to any fraudulent practices with the financial statement which would facilitate the overall functioning of the companies in the industry.

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