Introduction

Creative accounting is also known as earning management and referring to accounting practices that follows the letter of rules of standard accounting practices but certainly deviate from the spirit of those rules. Creative accounting practices are different from fraudulent practices and thus are not illegal but immoral in terms of misleading investors. The practices, which are followed in manipulating the books, are duly authorized by accounting system and thus can not 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.

Earning Management or Creative accounting is result of judgments which is used by managers in financial reporting and in maintaining books to manipulate reports for either misleading investors or stakeholders or to influence economy to give positive response towards financial performance of the company. The usual practice followed under earning management is to increase or decrease earnings artificially through choices available in accounting system.

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, analyzes 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).

However, in recent years, creative accounting is becoming increasing popular running through companies, which lead to considerable allegation about the practice of creative accounting. 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.

This chapter will start with identifying the qualitative characteristics of accounting information, defining the meaning of creative accounting through literature review and differentiating it with
frauds. It then provides a meaningful summary of the existing literature on creative accounting, delineates the incentives for creative accounting, and describe and analyze the most popular creative techniques used in recently.

**Methods & Techniques of Creative Accounting**

Following are the common creative accounting techniques followed by companies and give an idea to the regulatory bodies to focus:

1. Amortization of written off development expenditure over the life of asset of project. In order to produce desired results, a company can amortized written off development expenditure of related asset or project just to transfer the cost to next few years.

2. It has been observed that the life of the assets are determine by managers or organizational concerned department and thus long life assets will show depreciation for long time in books of accounts. These judgments or estimations in deciding for assets life may lead to creative accounting for getting desired results. If managers plan to evade taxes, they may estimate long life of assets of the company to show depreciation as expense for long time.

3. Sale and lease back transactions. In the transactions where third party is involved such as bank, the chances of creative accounting are more. While giving example Naser stated an example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

4. Choice in timing of transactions. Companies are free to record the sale or revenue to show profits of investment which was costing too low at historic price.

5. Transfer pricing methods in multinational companies. Tax advantages and tax differentiation in two different countries gives advantage to the companies to shift their profits in low tax regime countries. 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.

It has been observed that the major reason of occurrence of creative accounting is choices in accounting methods. According to many accounting standards, companies are free to use any of the method laid down in system subject to their convenience. For example there are three
broad methods of inventory pricing, FIFO (first in first out), LIFO (Last in first out) and average inventory method. Companies according to their convenience can choose any of the method such as in inflationary market FIFO method can be adopted if firm aims to reduce its expenses and wants to show higher profits. Each method will give different results in different conditions. Similarly, WDV (Written down value) and SLM (straight line method) of depreciation will give different result to the valuation of assets. These choices in methods of accounting give legal right to the companies to present desire picture of firm. Since, system authorizes companies to employ any of the method no matter if it misguides stakeholders thus people who are employing same can not be punished.

**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 I 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. In addition, corporate personnel who are responsible for checking the authenticity of reports are not knowledgeable enough to understand records presented to them.

Proposed research work has targeted the importance of understanding of investors and corporate personnel of financial reports. The study will focus on creative accounting motivations and applications. The role of regulatory bodies and investor’s contribution in motivating companies to indulge in creative accounting practices will be briefly discussed.
Literature Review

- **Orial Amat, John Blake and Jack Dowds (1999), Journal of Economic Literature classification:** Creative accounting is important for auditors or management to understand as it gives an opportunity to companies to manipulate things in desired manner but morally the practice is not acceptable. Government or concerned authorities have taken adequate steps to protect companies from such practices but till now no one has proven satisfactory. There are many users of financial statements who are not aware about creative accounting or earning management and thus management gets chance to mould the books in the way they want. While analyzing the study conducted by Orial and Catherine, we can conclude that there can not an adequate solution to the problem of creative accounting. But by making changes in accounting regulations we can control such practices such as by reducing the number of choices in accounting and by specifying method to follow in specific situation.

- **Herve & Gaetan(2004), “Accounting Manipulations: A Literature Review and Proposed Conceptual Framework”:** This paper highlighted the issue of manipulation and define accounting manipulations in different way and stated that manipulations depends upon the objective of getting into it. There is no appropriate way to remove such malpractices from the system but through promoting ethical mindset among the corporate world the chances of such practices can be minimized. The major reason stated by scholars for 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. Managers involvement in manipulating activities can be removed only when they can relate their organization with their efforts. An ethical mindset and awareness of investors about the financials and accounting methods can help in reduction of manipulating activities.

- **Frank Partnoy(2006), “How and Why Credit rating agencies are not like other gatekeepers” :** Credit rating agencies act as helping hand for stakeholders in investment decision. Since full expert team work on analysis of financial statements and parties involved are the independent one, investors feel that the data or information provided is reliable. These days the investors have started thinking over the rating procedure of credit rating agencies and strongly feel that rating should not be the only crietria for investment decision. After Enron, Satyam and WorldCom stakeholders and regulatory bodies have realized that there is no way to prevent financial market from manipulations as the people responsible in providing authentic information are manipulating the books for personal gains. The fee charged by credit rating agencies comes from the companies itself and thus better analysis will bring good amount of
fee. Thus personal gain automatically becomes a reason of loss of trust in CRAs rating system. CRAs in present situation needs to create a better image in market to regain the trust.

- **Naomi S. Soderstrom (2007), “IFRS Adoption and Accounting Quality: A Review” University of Colorado at Boulder, Accepted paper series extracted from Journal SSRN:** Accounting manipulations and creatively managing the accounts is becoming common practice these days and thus it becomes very important for the regulatory bodies to take an immediate step. In result of this around 100 countries have started following international financial reporting standards which will facilitate in harmonization of accounting standard and will try to minimize the chances of cross border accounting manipulations. In India the standards were supposed to implement in April 2011 but due to lack of knowledge and understanding of issues involved in its implementation the time period has been extended to April 2012. The standards involve many problems such as time and cost but the long term benefits may lead to solution of the problems of manipulations going in corporate world. Although the standards stated in IFRS are similar to GAAP principles but focusing on reporting standards makes a difference in system.

- **Luca Enriques (2000), “The Law on Company Directors’ self dealing: A Comparative analysis”:** Self-dealing transactions should not be treated as negative always, the intentions behind the transaction and its impact on long-term sustainability and profitability of the firm should be consider. The role of shareholders should also increase for bringing transparency and for creating ethical environment within the corporate world. Secondly, restriction may impose on related party transactions and companies should be strict in dealing with related parties in any of the way. However, self dealing transactions are treated in different way in different countries and there are many countries where self- dealing transactions are not restricted or prohibited and it is believed that these problem may exists if mangers are appointed as representative of shareholders and cannot be removed completely.

- **Michael G. Alles & Srikant M. Datar (2004), “How do you stop the books from being cooked” International Journal of Disclosure and Governance, International Journal of Disclosure and Governance:** According to this paper it is stated 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. Secondly, judgmental decision making and qualitative factors are giving undue advantage to management to mould the information in the desired manner. Last but not the least agency cost and difference in decision or opinion of managers and shareholders also motivate management to manipulate things as per the desired results.

- **Beneish, M. (1997).** Detecting GAAP violation: Implications for assessing earnings management among firms with extreme financial performance. *Journal of Accounting and Public Policy*: The findings suggest in this paper is that there is high probability of accounting manipulation in Enron’s financial statements for several years preceding its bankruptcy. It also suggest that considerable evidence existed that should have lead analysts, sophisticated investors, and regulators to question Enron’s financial results and soaring stock price.


- **R.H Grey (1995)“Business Ethics and Organizational Change”, Managerial Auditing Journal.** There is little evidence that the growth in organizational codes of ethics (OCoE) in recent years has had much effect on organizational activity. Such was also the experience with the social responsibility debate of the 1970s – a debate which the current business ethics experience so closely parallels. The theme here is that business ethics and social responsibility have failed to “root” because (a) they have remained undefined and imprecise, and (b) organizations have neither the mechanisms for, nor the interest in, their adoption. As a result neither ethics nor responsibility has entered the “soul” of organizations. Commentators have misunderstood this and continue so to do because the bulk of debate in the business ethics arena adopts the individualist orientation that characterizes much of the history of the philosophy of ethics.

- **Parviz Saeidi (2012),** “The relationship between income smoothing and income tax and profitability ratios in Iran stock” *Asian Journal of Finance & Accounting*: This is an empirical paper and shows the relationship between income tax and income smoothing practices. The hypothesis testing in this paper has prove that there is significant relationship between two and taxable income of income smoothing followers is less than that of non followers of income smoothing and it is also concluded by Dr. Parvez that there is significant relationship existed between profitability ratio and income smoothing.
Main Objective of Research Work

(i) To examine the role of accounting standards in motivating creative accounting practices and application of IFRS in its prevention

(ii) To assess the economic impact of creative accounting

(iii) To show an impact of investors knowledge and understanding about financial statement analysis in promoting creative accounting practices.

(iv) To analyze the knowledge level of investors and employees of financial statements and their probable contribution in prevention and detection of creative accounting practices
Research Methodology

The study is based on qualitative research method and data collection is based on following:

Secondary Data: Since the topic of creative accounting is critical and people tend to avoid answering such questions or issues. In such situation secondary data becomes an important source of collecting data and for supporting the research. Thus financial journals such as Management Accountant by ICWAI, journal of financial and strategic decisions and international journal of finance are consider for present study. The source of getting international journals would be DOAJ and Emerald. Newspaper and website for financial portals will also be an important source of secondary data to understand current scenario of corporate sector transparency.

However for better understanding of investors’ about the financials of proposed company for investment, a semi structured interview is conducted in Delhi/NCR region on more than 500 investors. The mode of getting responses will be through email or telephonic conversation.

Research Area: Present study will help corporate sector to understand the importance of awareness of accounting system and information among investors. The major area of research is corporate sector, multi nationals or public companies. After Enron, WorldCom and Adelphia it is very important for the corporate sector to assess the major loopholes in accounting system, which can be, use to manipulate the books in desired manner by management.

Research Design: Since the topic of research is accounting manipulation, we have to rely on secondary data and thus exploratory research study will be conducted whereby a problem will be formulated for investigation that is more precise. The major purpose would be to discover the ideas and insights.

Sample Size: More than 500 investors.
Procedure:

The questionnaire to both the respondents i.e. investors & corporate executives are different and thus are administered in different modes. Questionnaire to 120 investors are administered directly and out of which 83 investors responded and gave valid responses and questionnaire to corporate executives are sent through email. Corporate executives include 50 executives in the field of accounting & auditing. The total replies summed to 43. The procedure of data collection is done very carefully by checking their email addresses, in order to eliminate any possibilities of double answering.