

“CREATIVE ACCOUNTING PRACTICES: A CASE STUDY OF ENRON AND SATYAM SCANDALS”

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ABSTRACT

Creative accounting is a process by which the professional accountants use their knowledge to manipulate the figures in the annual financial statement and take advantage of the numerous options available to solve various accounting problems. It refers to accounting practices that follows the rules of standard practices but certainly deviates of those rules, characterized by excessive compliance and the use of novel ways of exhibiting income, assets or liabilities with an intention to influence the reader towards the interpretation of the desired result. In the present study the case of two big companies are taken in which creative accounting practices were adopted and that ultimately led to their sudden collapse. The paper highlights the reasons for the companies to adopt such practices and put forward suggestions which can help overcome this problem.

Keywords: Creative accounting practices, Enron Scandal, Satyam Scandal

INTRODUCTION

Creative Accounting also known as income smoothing, aggressive accounting, earning management, cooking the books, massaging the numbers are used to describe the practices of changing the facts in the books of accounts. It refers to accounting practices that follows the rules of standard practices but certainly deviates of those rules, characterized by excessive compliance and the use of novel ways of exhibiting income, assets or liabilities with an intention to influence the reader towards the interpretation of the desired result. Creative accounting or Earning Management is the result of judgment which is used by the manager in financial reporting to manipulate reports to give a positive response towards financial performance of the company. As such, the loopholes in the accounting standard facilitate the corporate sector to indulge in creative accounting practices.

It is unethical but not illegal because creative accounting practices are used by the company without violating the rules. Various creative accounting techniques are used by the companies to distort the true and fair view of the financial position of the company resulting in serious corporate failure.

The main reason for creative accounting is the choice available with the companies to use any of the accounting methods which are laid down in the system. The companies adopt different inventory pricing – FIFO (*first in first out*), LIFO (*last in first out*), and average pricing method to take advantage of the different market conditions. Even the methods of charging depreciation-WDM (*written down method*) and SLM(*Straight line method*) gives different results of valuation of assets. The system itself authorizes the companies to adopt any method without any accountability to the stakeholders.

OBJECTIVES OF THE STUDY

The main objectives of this study are to:

- (1) identify companies involved in fraudulent financial reporting practices and the nature of accounting irregularities they committed,
- (2) highlighting the Enron & Satyam Computers Limited’s (India)accounting scandal and
- (3) suggesting measures against adopting creative accounting practices by the companies.

RESEARCH METHODOLOGY

The present study is primarily based on “secondary” sources of data, gathered from the related literature published in the journals, newspaper, books, statements, reports etc.

Accounting frauds has affected many organizations throughout the world regardless of their size or location.

CREATIVEACCOUNTING IN INDIA

Globalization of the Indian corporate world has led to increase in opportunities for the Indian companies to go for “creative accounting” practices. Over the past few years there has been increase in the

accounting frauds in India. In spite of the stringent control by the regulatory authorities there have been number of accounting scandals since the 1980's.

According to Capital Via Global Research Ltd. (www.capitalvia.com), "The following are examples of some of the popular Indian Financial Market Scams (losses suffered): 1992 Harshad Mehta Securities Scam (Rs. 5,000 crores), 1995 Bhansali Scam (Rs. 1,200 crores), 2001 Ketan Parekh Scam (Rs.1250 crores), 2001 The UTI Scam (Rs. 4,800 crores), 2008 Satyam Scam (Rs. 10,000 crores), 2008 The 2-G Spectrum Swindle (Rs. 60,000 crores), 2009 Madhu Koda Scam (Rs. 4,000 crores), etc. etc. Fraud committed by the Satyam Computer Services Ltd. has been labeled by the media as "India's Enron." Some other popular scams were: Indian Coal Allocation Scam, Commonwealth Games Scam, Bofors Scam, Fodder Scam, Hawala Scam, The IPL Scam, Adarsh Housing Society Scam, Barak Missile Scam, Kargil Coffin Scam, Mining Scam, Telgi Scam and so on.

Creative Accounting and Fraudulent Practices followed by the Indian Companies

Companies	Year	Nature of Fraud
WIPRO Ltd.	1996-97 to 1999-2000	Transfer of land to stock creating capital reserve with the fair value and using it to neutralize the effect on profit of reduction of land value.
Bombay Dyeing & Manufacturing Company Limited	2003-04 and 2004-05	Creating provisions for possible loss on firm purchase contract and subsequent write-back of such provision thereby converting operating losses into operating profit.
Larsen & Toubro Limited	1999-2000 and 2001-02	Income recognition through transfer of loan liabilities at a lower consideration.
Apollo Tyres Ltd.	2004-05	Debiting profit and loss account with additional excise duty payable to the government and transferring equivalent amount from general reserve to neutralize the effect.
Asian Electronics Ltd.	2004-05	Impairment of assets: treatment of deferred tax
Oil and Natural	2004-05	Capitalization of interest as well as other intangible assets to show
Gas Commission, Mukund Ltd., Torrent Power ACE Ltd. And Tata Motors Ltd		fixed assets value upward and understating revenue expenses.
Hindustan Zinc Limited	2003-04 and 2004-05	Reclassifying assets in the balance sheet.
Tata Motors, Bombay Dyeing, Mahindra and Himachal Futuristic	2001-02	Direct write-offs from reserves.
Satyam Computers Services Limited	2008-09	Fraudulently incorporated a non-existent cash component by inflating the bank balances, fudging bills, accounts receivables, interest, and liabilities.
(Source: Jones, M. (2011) 'Creative accounting, fraud and international accounting standards,' John Wiley & Sons, London, page 235)		

REASONS OF USING CREATIVE ACCOUNTING PRACTICES BY COMPANIES

Inspite of the scandals companies are still using creative accounting practices to manipulate the accounts and get it audited to present to the stakeholders as desired by them. Creative accounting techniques do not violate the rules of the law. The companies are motivated to use the varied techniques for the following reasons-

- ✓ **Income smoothing:** A stable company help retain the investors and for this the companies makes provisions for liabilities against the value of assets in high income generating years and utilize the same in the lean years. This effort by the company help retain the confidence of the investors I turbulent environment and also help in reducing corporate taxation.

- ✓ **To tie in to forecasts** It is an important variant of income smoothing which is used by companies to design the accounting policies and rules to match reported earnings to profit forecasts. So by this method they can maintain the trends of income from year to year and they can predict the future earnings easily by using the past trends of income.
- ✓ **To distract attention from unwelcome news:** companies use income-boosting accounting policy to distract attention from unwelcome news. Creative accounting is used as a technique to present a stable profit generating company amidst unwelcome news.
- ✓ **Maintain or boost the share price:** Companies use creative accounting practices to maintain or boost the share price. This is done by them by communicating to investors that the firm has higher earning power, which is likely to lead to a higher share price.
- ✓ **To get advantage of insider information:** Directors of a company who are involved in insider dealings in the shares of the company. Instead of releasing the inside information for the public they use it for their own benefit thereby they try to enhance their opportunity get benefit from inside knowledge that they have about the shares of the company.
- ✓ **Satisfying all interested groups:** conflict of interest among different interest groups is also an incentive for the companies to use creative accounting practices. Investor-shareholders want to get more capital gains and dividends, while employees want to get higher salary, bonus and profit share, managing shareholders' want to pay less taxes and dividends, tax authority of the country wants to collect more taxes it becomes difficult to satisfy all the stakeholders and as a result companies are compelled to use creative accounting practices to satisfy all the interested people.
- ✓ **Tax:** An important motivator for the companies to manipulate the accounts is the tax. Large and high-profit firms may have the incentive to manage their earnings downward to not to come in the eyes of regulators and thus less likely to pay higher taxes. If the company wants to pay less tax in any year it will manipulate the income in such a way so that the company is supposed to pay less tax in that year.
- ✓ **To get Government Assistance:** when a company has to face foreign competition, it may need help from the Government of its country and the government will need to make sure that the company is indeed struggling to survive in the market. Therefore, instead of moving up the profit, the company needs to lower its profit to strengthen the case of the company to get government assistance.

IMPACT OF CREATIVE ACCOUNTING USING ENRON AND SATYAM SCANDAL AS THE CASE STUDY

As discussed above the companies have reasons to use creative accounting practice without considering its impact in future. For this Enron (USA) and Satyam(India) scandal cases are taken into account to study the negative aspect of creative accounting and how its practices lead to collapse of these companies.

ENRON SCANDAL

Enron Corporation was formed in July 1985 through a merger of Houston Natural Gas and Inter mouth, two natural gas pipeline companies. It was 7th largest company of the country. The main function of this company was to facilitate the transportation of gas between producers and utilities. But in 2002 the company collapsed which was the outcome of creative accounting practices used by the company. The company used the most common method of creative accounting technique-**special purpose entities**. SPEs are non-consolidated, off balance-sheet vehicles, used to move assets and liabilities off the balance sheet, where substantial amounts of debt were removed from the accounts. Through SPEs, the risk of the company can be reduced by moving assets into separate partnerships called SPEs. Through SPEs a company can finance their activities with a lower-cost debt which can be kept off balance sheet by using the weak accounting rules for SPEs. As per the accounting standards SPE need to be separate from the company which created it but in case of Enron this standard was overruled. Even the assets with falling value were sold to partnerships and were listed as earnings.

Enron adopted **Mark-to-market accounting** for contracts through the **Volumetric Product Payments** (VPPs). This approach helped Enron predict the future cash flows from VPPs contracts and after applying the discount rate on those cash flows, it was able to take decisions whether the underlying asset to be sold to SPEs or to be shown as merchant asset in the books of the company.

Another creative accounting in which Enron participated was **In-and-out trading**. This happens when two or more traders buy or sell among themselves for the same price at the same time. This does not have any effect on the profits but it shows inflated sales which is the main indicator of performance of the company to the investors.

SATYAM SCANDAL

Two brothers B Rama Raju and B Ramalinga Raju started a private limited company with the name Satyam Computer Services Limited on 24th 1987 (SATYAM) which got converted into public in 1991. The company provided IT services to big corporate world bank to provide IT services but suddenly on grounds of unethical behavior the world bank broke the contract in 2008. On 7th January 2009 Ramalinga Raju confessed a fraud of Rs.7800 crore and the two brothers were booked for cheating, breach of trust, forgery & conspiracy as a criminal under IPC. Consequently, Tech Mahindra (holding 31% stake in Satyam) who has given highest bid for the company bought it and on 21st June 2009, it renamed as 'Mahindra Satyam. The sudden collapse of SATYAM was due to following reasons:

- Tax evasion and manipulation of accounts (creative accounting practices) were the prime factors for the collapse of the company. Above all, unethical conducts followed by the company augmented the problem.
- Fictitious figures and fixed deposits were shown in the books. An accrued interest of Rs. 376 crore which did not exist and payment of taxes about Rs.186.91 crore on account of accrued interest of Rs. 376 crore was shown in the accounts which lead to falsification of accounts.
- Board members failure to raise voice against the company's malpractices and the unconvinced role of the independent auditors contributed towards its collapse the Audit Committee entrusted with the task of ensuring transparency failed to depict the true and fair view of the company.
- Credit rating agencies failed to fulfill their responsibilities as they rated Satyam without thorough analysis which in turn misguided the investors regarding the creditworthiness of the company.
- Banks also failed to diligently play its role while granting loans, the auditing firm PricewaterhouseCoopers (PwC) prepared the report that misled the stakeholders.
- It was found that Mr. Jose Abraham, an ex-senior executive of the company, blew the whistle on the Satyam scam. But no action had been taken on his whistle.

SUGGESTIONS AND RECOMMENDATIONS

As such creative accounting is an art of playing with the figures and accounts of a company without breaking the rules. Various measures can be taken to minimize the scams and scandals and contribute towards the smooth functioning of the companies.

- In the present scenario companies must be committed towards corporate governance and ethical practices and it should be implemented in a true sense.
- There is a dire need for a separate review department in the companies to continuously review the accounting policies and rules and assure its implementation.
- The auditors play a crucial role in prevention and detection of creative accounting practices. The role of the credit agencies is also crucial as it helps the investors take investment decisions and they rely on the data provided by them. The agencies should be more transparent and impartial while rating the companies.
- Directors should be competent to take bold decisions in case of unfair practices followed by the company
- Introduction of accounting standards will help prevent creative accounting practices.
- An entrepreneurial friendly environment created by the government would help overcome the problem of creative accounting practices.

CONCLUSION

The urge of the companies to remain in the competitive market has been one of the biggest of motivator of creative accounting. In case of Enron and Satyam too the practice of creative accounting was adopted, this ultimately led to sudden collapse of these companies. The companies should totally avoid using short term benefit of creative accounting as its creation lies with the owners of the company. The introduction of international accountings standards will also help prevent the creative accounting practices. The government has also to play a crucial role in creating entrepreneurial friendly environment which will help prevent creative accounting practices by the companies.

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