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RESEARCH ARTICLE

A STUDY ON THE PRESENCE OF CREATIVE ACCOUNTING PRACTICES: INDIAN OVERVIEW

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ABSTRACT

Transfer of accurate and timely financial information to the interested parties inside and outside the company is the main role of financial reporting. To this purpose, managers have opportunities to apply their judgments in financial reporting. Managers can use their knowledge about business activities to improve effectiveness of financial statements as a tool for transferring information to potential investors and creditors. However, if managers had incentives to mislead users of financial statements through exerting their authorities on accounting options in financial reporting, creative accounting would occur. Today, creative accounting is considered as one of interesting subject in accounting studies and it is defined as conscious behavior performed to reduce periodic fluctuations of earnings. Generally, researchers believe that managers consider income smoothing in order to present a sustainable picture of profitability in the flexible framework of common accounting principles and methods. Some evidence indicates that most of stockholders and creditors incline to invest in firms the management of which is able to provide a smoother picture of profitability. Motivationally, creative accounting is a qualitative item affected by several factors. In the present study it has been tried to study regarding the presence of creative accounting practices in the form of income smoothing.

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INTRODUCTION

Prologue: Transfer of accurate and timely financial information to the interested parties inside and outside the company is the main role of financial reporting. To this purpose, managers have opportunities to apply their judgments in financial reporting. Managers can use their knowledge about business activities to improve effectiveness of financial statements as a tool for transferring information to potential investors and creditors. However, if managers had incentives to mislead users of financial statements through exerting their authorities on accounting options in financial reporting, creative accounting would occur. Today, creative accounting is considered as one of interesting subject in accounting studies and it is defined as conscious behavior performed to reduce periodic fluctuations of earnings. Generally, researchers believe that managers consider income smoothing in order to present a sustainable picture of profitability in the flexible framework of common accounting principles and methods. Some evidence indicates that most of stockholders and creditors incline to invest in firms the management of which is able to provide a smoother picture of profitability. Motivationally, creative accounting is a qualitative item affected by several factors. In the present study it has been tried to study regarding the presence of creative accounting practices in the form of income smoothing.

Creative Accounting: Creative accounting is the science and art of making the accounts look attractive within the existing parameters of performance. In essence, creative accounting makes for a half-filled glass of water look like half-full rather than half empty.[1]

The term 'creative accounting' can be defined in a number of ways. Initially we will offer this definition: 'a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business'[2]
Griffiths as a business journalist writing from perspective of a business journalist, observes: "Every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan Horse……….In fact this

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deception is all in perfectly good taste. It is totally legitimate. It is creative accounting." [3]

Concept of Income/Profit Smoothing: The term-Income smoothing refers to a kind of Income management that reflects economic results according to the management wish. Accordingly, the income does not portray the real economic performance of the business entity for the period. Income smoothing not only relies on falsehoods and distortion but on the various alternatives available in accepted accounting principles. It is conducted within the structure of Generally Accepted Accounting Principles (GAAP). The prime objective of Income-smoothing is to moderate income variability over the years by shifting income from good years to bad years. Future income may also be shifted to present year or vice versa. In similar way, income variability can also be modified by shifting expenses or losses from period to period. For example advertising expenses in the current year may be reduced to improve current year's earnings. In the next year, the advertising expenses may be increased. Income smoothing does not mean showing higher income to the interested parties but it means showing a desired level of earnings over a period of time.[4]

Beidleman (1973)[5] defined income-smoothing as an attempt on the part of the firm's management to reduce abnormal variations in earnings to the extent allowed under sound accounting and management principles. Income smoothing is defined as a deliberate dampening of fluctuations about some level of earnings considered to be normal for the firm – Barnea *et al* (1976).[6]

Objective of the Study

The present study has been undertaken taking into mind the broad objective of determining the presence of income smoothing practices among the listed companies in India.

Size of the Population: During the tenure of the research study, the number of listed companies in the NSE as on 31st July 2014 has been 1652. In statistics, a population is a complete set of items that share at least one property in common that is the subject of a statistical analysis. However for the present study total population has been taken as the companies included in CNX Nifty because **criteria for selection of constituent stocks are common for all the stocks viz Liquidity (Impact Cost), Floating Stock etc.** The population consists of 50 companies and out of these 50 companies; finance sector companies have been excluded. The finance sector companies have been excluded from the study because of its unique characteristics of financial reporting practice. The number of companies included in CNX Nifty after excluding finance sector companies stands at 40. This has been taken as the population for the present study.

Size of the Sample: It has been decided on the basis of Cochran's model of sample determination. The sample has been fixed at 30 which have been decided on the basis Cochran's sample determination literature. Judgmental sampling technique has been used for drawing these 30 companies from the population of 40 companies. The sample size of 30 is 75% of total population of 40 and this 75% has been taken as the criterion to select sample companies proportionately from private and public sector. Accordingly, out of total 32 private sector companies, 24 (75% of 32) has been taken as the sample companies. Similarly, out of total 8 public sector companies, 6 (75% of 8) has been taken as the sample companies.

The Method of Data Collection adopted has been selected keeping in view the nature, scope and object of the present study. Primary data in the form of published Annual reports of the companies have been collected by post, fax and internet. Data has been collected for a period of 10 years i.e. 2003-2004 to 2012-2013.

Measuring income smoothing

In this research study, the procedure employed to determine the presence of Income Smoothing is the coefficient of variation method developed by Eckel (1981).

As per the model, a firm is not classified as an income smoother if [7]

$$CV_{\Delta I} \geq CV_{\Delta S}$$

where

I=One period change in income

S=One period change in sales

CV=Coefficient of variation

$$CV = \frac{\text{Standard Deviation}}{\text{Mean}}\left(\frac{\dagger}{a}\right)$$

The actual objectives of income-smoothing with respect to the income statement have been interpreted in various ways. Some studies suggest net income as the ultimate aim of smoothing. Ronen and Sadan (1981)[8] propose that the object of smoothing is ordinary income. Imhoff's (1981)[9] possible measures of income-smoothing include net income, operating income[7]. In the present study, the objective of income-smoothing has been taken as PBT

The present study modified the original Eckel's model and assumes a company as non-smoother if

$$CV_{\Delta I} = CV_{\Delta S}$$

The logic behind this assumption is that if the income figure and sales figure of a company are taken over a period of time, then, the Coefficient of Variation of income i.e. the variation of change in income and the Coefficient of Variation of sales i.e. the variation of change in sales should be same. So the company where the $CV_{\Delta I} > CV_{\Delta S}$ or $CV_{\Delta I} < CV_{\Delta S}$, it will be considered as a smoother company.

In the present study, a company is considered as a non-smoother even if-

$$CV_{\Delta I} \approx CV_{\Delta S} \text{ i.e.} \frac{CV_{\Delta I}}{CV_{\Delta S}} \approx 1$$

In the study, the ratio of CV of PBT to CV of sales is used as Eckel's Index (Income-Smoothing Detector) to identify the sample of the company's as smoother and non-smoother.

Findings of the Study

Eckel's Index has been calculated as an indicator of income smoothing practice using ratio of Profit before Tax and sales. Out of the total 30 sample companies only 3 (10%) companies are found to be non-smoother as in case of these 3(10%) companies, the Eckel's Index is approximately equal to 1. At the same time, out of the 30 companies, 27(90%) are found to be smoother as Eckel's Index for these companies are either greater than 1 or equal to 1.

The objective of the study deals with the question of whether creative accounting in the form of income smoothing is prevalent among the listed companies in India. However, from the descriptive statistics, it has been found that 27(90%) companies are involved in income smoothing activity whereas only 3(10%) companies are proved to be non-smoothers. Many previous studies proved the presence of income smoothing among the companies. But for this paper, the study undertaken by Kamarudin *et al*[10] among the companies listed in the Kuala Lumpur Stock Exchange has been used as benchmark for comparison. The findings of the study showed that the number of smoothing firms was smaller compared to non-smoothing firms where 81(71%) firms are classified as non-smoother and 33(29%) firms as smoother. The study concluded that smoothing is present among the companies but at a lower level. Since the percentage of smoother companies in the present study has been much higher as compared to the study undertaken by Kamarudin *et al* among the companies listed in the Kuala Lumpur Stock Exchange, it can be concluded that smoothing is prevalent among the listed companies in India at a higher level.

Epilogue: The present researchers have established by way of their research findings that a substantial portion of companies listed with the NSE are smoothing(either they are overstating or understating certain pivotal accounting numbers) which is inter alia against the principles of the Agency Theory of Corporate Governance.

It is worth mentioning here that sometimes the company management reluctantly willing to use the Creative Accounting path. The use of Creative Accounting also increases the Agency cost for resolving the agency problems.

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