Abuse of Creative Accounting: A Case Study of Satyam Computer Services Ltd.

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1. Introduction

Creative accounting refers to the accounting practices that may or may not follow the accounting principles or standards but deviate from what these principles or standards intend to achieve, in order to show a desired image of the company to the stakeholders. According to Naser (1993), “Creative accounting is the transformation of financial accounting figures from what they actually are to what preparer desires by taking advantage of the existing rules and/or ignoring some or all of them”.

Creative accounting is also known by the terms income smoothing, earnings management, earnings smoothing, financial engineering, cosmetic accounting, big bath accounting, and window dressing. Creative accounting uses the loopholes in accounting principles or standards to show the desired results to the stakeholders. The loopholes in accounting such as, estimation of useful life of an asset within the company for the purpose of depreciation, and choice between a policy of writing off research and development expenditure as it occurs and amortizing it over the life of the related asset, helps the companies to use their discretion to meet its requirements. Amat et. al. (1999) have described the various methods of creative accounting which are generally used by companies. Some examples of creative accounting practices are artificial transactions to manipulate balance sheet amount and increase profit between accounting periods like booking fictitious sales, and timing of genuine transactions to give the desired impression in accounts.

The various motives for the use of creative accounting practices by companies include smoothing income to report a steady trend of growth of profit, manipulating profit to meet the forecasts, distracting attention from unwelcome news by using an income boosting accounting policy, maintaining or boosting the share price to raise capital from fresh issue, delaying the release of information for the market for earning personal profits by insiders trading, availing tax benefits, and showing poor management by old management in case of change in management.

A question that arises very often is, whether creative accounting is good or bad. The answer to this question lies in the purpose for which it is used and whether it is in conformity with the existing accounting principles or standards. It is legal and ethical if it is done using the discretion in the accounting principles or standards with the objective of saving the company in hard times without any intention of making the private gains by the management. However, it is unethical and illegal if it does not follow any rule/principle or standard and it is used by the management to make private gains at the cost of other stakeholders.

In the modern globalized and liberalized era, the firms are facing stiff competition and are under pressure to show the good financial results through financial reporting. In such an environment, they start using the creative accounting practices, especially in unsuitable situation to boost up the profit or manipulate the assets and liabilities to report to the stakeholders the image that is better than the actual image. It is in this context, the present paper seeks to discuss the conceptual framework related to creative accounting. It also makes an attempt to analyze the case of Satyam Computer Services Ltd. (2009) to explain as to why and how the management abused creative accounting. Moreover, it also provides suggestions for detection and prevention of abuse of creative accounting.

2. Review of Literature

The studies which deal with the various dimensions of creative accounting have been reviewed for the purpose of writing this paper. Some of the reviewed studies are as follows:

Amat et. al. (1999) conducted a study on various dimensions of creative accounting such as, some definitions of creative accounting, various ways in which creative accounting can be undertaken, the
range of reasons for a company’s directors to engage in creative accounting, ethical issues that arise in creative accounting, and surveys of auditor’s perceptions of creative accounting in the U.K., Spain, and New Zealand. They found that New Zealand offered an example of a country where a well-designated framework of accounting regulation has curbed creative accounting.

Healy and Wahlen (1999) describe how standard setters should decide or make accounting standard to reduce the possibility of earnings management. They pointed out that the standards add value if they enable financial statement to show difference between the relevance and reliability of accounting information under alternative standards. They found that the managers manipulate the financial numbers to increase their management compensation, to provide low salary to employees, and to pay fewer dividends to shareholders.

Rabin (2005) described the auditor’s attitude towards creative accounting and ethical behavior of auditors. He identified that relevance and reliability are more important than understandability in assessing the quality of financial information. He found that the major factors that influence the use of aggressive accounting by management included meeting analyst and management targets, maximization of remuneration, and lack of corporate governance.

Shah et. al. (2011) used the discussion based model to answer the question that why managers do creative accounting and how they become successful in performing such practice in the presence of stringent rules and procedures. They also explored the link of governance with creative accounting practices. They found that the creative accounting solutions are not always wrong. They concluded that the complex and diverse nature of business transactions, and the latitude available in the accounting standards and policies make it difficult to handle the issue of creative accounting.

Bhasin M (2013) examined the India’s Enron, Satyam Computers Creative Accounting Scandal. He found that the Satyam fraud was due to human greed, ambition, and hunger for power, money, fame and glory. He highlighted the importance of securities laws and corporate governance in emerging markets. He suggested that the increasing rate of white-collar crimes demands stiff penalties, exemplary punishments, and effective enforcement of law with the right spirit.

Soral and Kamra (2013) explored the ethical and unethical aspects of creative accounting with the help of cases from India and abroad. They also examined the effects of creative accounting on selected companies. They found that the different companies were using creative accounting practices differently and the large size companies have more scope for using creative accounting practices. They also found that although foreign companies have extreme knowledge of creative accounting practices, yet big accounting scandals are also taking place in foreign companies in comparison to Indian companies. They concluded that the unethical practices are motivated by lack of global financial accounting infrastructure.

Rajput (2014) discussed the concept of creative accounting, motivations for its uses, creative accounting techniques, ethical issues concerning creative accounting, and possible solutions for the problem of creative accounting. He also studied the various accounting scandals in other countries. He found that creative accounting has become a convenient way of sustainability in the competitive era. He also found that creative accounting exist due to lack of awareness and information level of investors. He highlighted the role of Government and various agencies like SFIO and India Forensic for proper handling of the problem of creative accounting.

Renu and Aggarwal (2014) highlighted the creative accounting in negative sense with the help of creative accounting methods adopted by Enron Company and Satyam Computers which led to the collapse of these two. They concluded that creative accounting is unethical and a negative aspect of accounting.

Yadav (2014) discussed the various aspects related to creative accounting such as, type of creative accounting, parties involved in creative accounting, motivation factors for creative accounting, effect of creative accounting on the performance of the company, corporate governance as a solution for creative accounting, and ethical responsibility for creative accounting. He found that the creative accounting practices increase when managers want to boost the profit in case of unsuitable situation. He suggested that creative accounting practices can be minimized by corporate governance practices.
The reviewed studies are on different aspects of creative accounting. No study has been undertaken on all the aspects of creative accounting, which are considered under the present paper. The present paper seeks to discuss the conceptual framework related to creative accounting, analyzes the abuse of creative accounting in Satyam case, and provides suggestions for detection and prevention of abuse of creative accounting.

3. Objectives
The present paper aims to achieve the following objectives:
(i) To discuss the conceptual framework of creative accounting.
(ii) To analyze the case of Satyam Computer Services Ltd. (2009) to explain as to why and how the management abused creative accounting.
(iii) To give suggestions for detection and prevention of abuse of creative accounting.

4. Methodology
A detailed study of the literature related to creative accounting has been made for the purpose of writing this paper. The study is based on secondary data which has been obtained from various published sources, websites, books, articles, and journals. The sources of information have been properly acknowledged. The discussion based model has been used on the basis of past references and experiences. The case of Satyam Computer Services Ltd. (2009) is analyzed to explain as to why and how the management abused creative accounting. This case has been especially selected for the purpose of present paper as the abuse of creative accounting in this case resulted in the biggest India’s corporate fraud of around Rs. 7000 crores.

5. Satyam Computer Services Ltd. (2009)
The analysis and discussion of abuse of creative accounting in case of Satyam Computer Services Ltd. (2009) is as follows:

Analysis
Satyam Computer Services Ltd. (Satyam) was founded in 1987 by Ramalinga Raju and his brother Rama Raju as a private company with just 20 employees to develop software and provide consultancy services to large corporations. By the end of 2008, the company became the fourth largest IT Company of India. The company earned the distinction of ‘India’s one of the most remarkable and entrepreneurial companies’ from the World Economic Forum. In 2008, the company received the “Golden Peacock Award” for excellence in corporate governance from London based World Council for Corporate Governance. Despite all the awards and recognition which the company secured, the biggest India’s corporate fraud of around Rs. 7000 crores was discovered in Satyam on Jan. 7, 2009, due to the creative accounting practices used by management. Tech Mahindra purchased 51 percent of Satyam on April 16, 2009, successfully saving the firm from a complete collapse.

B. Ramalinga Raju, founder and CEO of Satyam Computers, announced all of sudden on Jan. 7, 2009 that his company had been falsifying its accounts and doctoring the books of accounts of the company for years. As per his confession letter to the board of directors dated Jan. 7, 2009, company’s financial statements had overstated cash reserve of Rs. 5040 crores which did not exist, accrued interest of Rs. 376 crores, overstated debtors of Rs. 490 crores, and understated liabilities of Rs. 1230 crores. As per the confession the company has also inflated its 2008 second quarter revenues by Rs. 588 crores to Rs. 2700 crores and actual operating margins were less than a tenth of stated Rs. 649 crore. Raju was compelled to admit to fraud following an aborted attempt to have Satyam invest $ 1.6 billion in Maytas Properties and Maytas Infrastructure- two firms promoted and controlled by his family members. The aborted Maytas acquisition was the last attempt to fill the fictitious assets with real ones. The Indian Authorities arrested Mr. Ramalinga Raju, his brother B. Rama Raju, its former managing director, Srinivas Vdlamani, the company’s head of internal audit and its CFO on criminal charges of fraud. The authorities also arrested and charged several of its auditors with the fraud.

As per Serious Fraud Investigation Office (SFIO) Report (2009), The Satyam fraud started in 2001 with falsification of accounts. The aim of the scam was to prop up the shares of the company and boost
market value by showing exceptionally good financial results. The promoters quietly sold the shares at inflated price and used the proceeds to buy land to take advantage of booming real estate at that time. In March 2001, the stake of promoters was 25.6 percent which as a result of off-loading came down to 2.18 percent in Dec. 2008. The scale of the fraud accelerated in mid-2007 when the company showed huge cash balances and fixed deposits in several banks of international repute. It was, however, actually starved of funds and the promoters were desperate to raise money to keep the company afloat. As per Securities Exchange Commission (SEC) of U.S.A., the fraud started with creating fake invoices for services not provided. These fake invoices then entered the company’s financial statements adding $1.1 billion from the fiscal 2004 to the second quarter of fiscal 2009. After creating fake invoices and generating false revenues, the next step was to show these as cash receipts. Therefore, the senior management falsified the bank statements that showed the higher bank balances than what was actually. The next level of fraud was to falsify interest on fixed deposit receipts to show that fictitious bank balances were earning interest income.

Discussion
The Satyam Fraud is clearly a case of abuse of creative accounting in which the accounts were manipulated by creating fake invoices for the services not rendered, recognizing revenue on these fake receipts, falsifying the bank balances and interest on fixed deposits to show these fake invoices are converted into cash receipts and are earning interest. The purpose was to inflate the share price of the company and sell the promoters holding at inflated price. This type of creative accounting is illegal and unethical. As a result of this fraud, the share of the company fell drastically from Rs. 178.95 on Jan. 6, 2009 to below Rs. 40, wiping out Rs. 9376 crores of investors’ wealth in just one day. The Satyam fraud seriously affected all the stakeholders of the company, i.e., employees, clients, shareholders, bankers, and Indian Government.

The creative accounting in Satyam case is a total failure of corporate governance. It was possible because of small holding of the promoters, non-disclosure of pledging of promoters shares, failure of the board of directors and audit committees in discharge of their duties and flaws in external audit. The Price Waterhouse India, the company’s auditor since 2000 failed to conduct the audit as per prescribed standards. They did not contact the banks directly for reconciliation of the significant differences in cash balances reported by management and the cash balances confirmed by bank. They also did not confirm account receivables from customers. The fraud could have been caught earlier if the auditors had followed the due diligence.

6. Recommendations
The various suggestions for detection and prevention of abuse of creative accounting are as follows:

(i) The audit committees of the board should consist of independent and non executive directors. The independent directors should be selected by shareholders. Moreover, the top management of the company should be carefully selected.

(ii) Auditors of the company should be periodically rotated and they should not work under any pressure of the management. They should check all the information and seek further information from the management if they are suspicious of any financial irregularity. They should do the due diligence while auditing the books of account of the company.

(iii) Companies should have an efficient whistle blower system in which the employees are encouraged to report to the management any financial irregularity. The companies should also ensure that the whistle blower is not victimized by the people who are involved in that financial irregularity.

(iv) Companies should have sound system of internal check and internal control with division of responsibilities across a team of people so that any financial irregularity can easily be detected.

(v) The regulatory authorities should carefully examine the cases of pledging of shares and selling of shares by promoters and controlling shareholders. This will help in early detection of cases of abuse of creative accounting.
(vi) The regulatory authorities should ensure that various laws and regulations are strictly followed by imposing heavy penalties for non-compliance.

(vii) The Institute of Chartered Accountants of India should develop a course on ethics in accounting and make it mandatory for all the people who are associated with accounting and auditing of companies.

(viii) The regulatory authorities and the professional bodies should organize more campaigns for awareness and education of investors. Financial literacy of investors will help them to detect the cases of use of creative accounting by carefully analyzing the annual reports of the companies.

7. Conclusions

In the modern globalized and liberalized era, the firms are facing stiff competition and are under pressure to show the good financial results through financial reporting, either by the use or abuse of creative accounting. The use of creative accounting has helped many companies to get out of crises situation and the abuse of creative accounting has landed many companies into crises situation. Creative accounting is like weapon which can be used or abused by the management. If, it is abused then the fault is of management and not of creative accounting itself. The Satyam fraud is clearly a case of abuse of creative accounting in which the accounts were manipulated by creating fake invoices, recognizing revenue on these fake receipts, and falsifying the bank balances and interest on fixed deposits. The purpose was to inflate the share price of the company and sell the promoters holding at inflated price. The abuse of creative accounting in case of Satyam was possible due to audit failure and total failure of corporate governance. The abuse of creative accounting can be prevented and detected by the measures like good corporate governance by management, periodic rotation of auditors, due diligence by auditors, efficient whistle blower system, sound system of internal control and audit, timely examination of the cases of pledging or selling of shares by promoters and controlling shareholders, heavy penalties by regulators for non-compliance to any regulation, mandatory course on ethics in accounting and auditing by Institute of Chartered Accountants of India, and more campaigns on awareness and education of investors by regulatory authorities and professional bodies.

8. References

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