

The Impact of Forensic Accounting on Reducing Creative Accounting Techniques

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ABSTRACT

Forensic accounting is a specialized area within the field of accounting aimed at addressing non-uniformity and preventing misleading practices that stem from creative accounting. It encompasses expert knowledge and diligent skills used to detect and mitigate financial fraud while identifying intentional manipulations within financial records that exploit loopholes in accounting standards. This paper explores the scope of forensic accounting and the strategies it employs. It also focuses on creative accounting practices prevalent in India, highlighting the issues they pose and proposing solutions through forensic accounting. The research discusses the concept of forensic accounting and emphasizes its critical role in corporate organizations.

Keywords: *Forensic Accounting, Creative Accounting, Financial frauds, frauds*

The techniques of creative accounting can be used in an unacceptable way in the preparation of the financial statements in order to meet management needs with regard to the performance of the company, and this leads to the misleading of financial statements (Balacia, 2008). Creative accounting refers to the intentional effort to smooth income through manipulation of financial statement items, which can be harmful in the long term (Merchant and Rockness, 1994). It involves deliberate management interference in the financial reporting process (Schipper, 1989), utilizing various accounting methods, estimates, and practices permitted under accounting standards. The motivation behind creative accounting often stems from tax obligations based on income, the desire to maintain shareholder and employee confidence in management's capability and stable performance, and meeting psychological expectations linked to projected income changes (Hepworth, 1953).

Overall, creative accounting is considered deceptive and undesirable, which highlights the need for professionals with expertise in accounting to investigate and provide assessments for cases involving misrepresentation and fraudulent financial practices. This field, known as forensic accounting, involves specialized knowledge of accounting and thorough examination of financial reports to ensure their accuracy and transparency.

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Objectives

1. To develop the insight about Forensic Accounting.
2. To understand the relation of Creative Accounting with Forensic Accounting.

LITERATURE REVIEW

Ismael Adam (2017), shows the impact of creative accounting techniques on the reliability of financial reporting with particular reference to Saudi Arabia Auditors and Academics. The study has been used primary and secondary data. The study concludes that the statutory auditors can play an effective role in reducing the effect of creative accounting techniques on the reliability of financial reporting.

A. Oluwatosin (2021) explores the forensic auditing and fraud detections in the Nigerian deposit money banks. The study has been served 132 Questionnaire to six money banks. The examined the impact of forensic audit on the prevention of fraud on the deposit money bank. The study concludes that there are significant effects of forensic accountings skills on the detection of fraud in the banking sector.

Ogutu and Ngahu (2016) highlighted that the proficiency and training of accounting personnel significantly enhance the ability to prevent fraud. Their study identified essential traits for forensic accountants, such as analytical skills, ethical integrity, and confidence. Additionally, they emphasized the importance of auditing skills, investigative capabilities, and legal knowledge for accountants.

Okere, and Aro (2018) examined the underlying reasons for the ineffectiveness of anti-corruption agencies and reforms in Nigeria, advocating for the involvement of forensic accountants to combat escalating corruption. Their findings stressed the necessity of thoroughly analyzing government financial statements to ensure their authenticity and reliability.

Formigoni (2013) distinguished forensic accounting from auditing, establishing it as a specialized career in developed nations. The study emphasized aligning forensic accounting practices with international standards to uncover fraudulent or suspicious transactions. Furthermore, it revealed that weak internal controls and inadequate regulations often contribute to corrupt management practices.

Bhasin (2015) investigated the prevalence of creative accounting, which facilitates unethical advantages for accountants, administrators, and organizations. The study recommended stringent measures, including enhanced regulation of auditing, accounting, and corporate governance practices, to prevent such unethical practices.

El-Mousawi (2020) explored the inverse relationship between forensic and creative accounting. They proposed that the Integrated Audit approach, a key method in forensic accounting, is highly effective in mitigating creative accounting practices. The study also suggested introducing forensic accounting as a specialized certification course and organizing training programs to help professionals adapt to evolving business accounting practices.

Creative Accounting Practices

Creative accounting involves the strategic presentation of financial figures, often influenced by cognitive reference points. It typically entails manipulating financial statements, such as

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the balance sheet, to reclassify liabilities, thereby portraying an improved liquidity position and healthier leverage ratios (Gramlich, 2001). Some common techniques include:

- **Inflating expenses** by overstate depreciation on fixed assets.
- **Shifting current-year expenses** to future or prior years.
- **Overestimation of Intangible assets** to enlarge financial appearance.
- **Recording bogus expenditures** to manipulate costs.
- **Manipulating inventory values** to distort profit or financial health.
- **Overstating depreciation rates** to reduce the value of fixed assets.
- **Falsifying cash flow figures** to minimize tax liabilities.
- **Overestimation or underestimation of inventory** and mispricing scrap materials.

These practices depict the true financial position of a company and undermine the reliability of financial reports.

The potential for creative accounting can be summarize into six key principles: regulatory flexibility, the absence of uniform regulations, broad managerial discretion over reserves and provisions, strategic timing of transactions, reclassification, and the presentation of financial data. These principles enable the preparation of financial reports tailored to achieve specific objectives, often facilitating managerial fraud and income smoothing. This environment has become fertile ground for financial scandals and techniques involving asset misappropriation, commonly classified as white-collar crime. To address these unethical practices, a specialized branch of accounting emerged, known as **Forensic Accounting**, dedicated to uncovering and preventing such manipulation in financial records.

Need for Forensic Accounting

Black (2010) highlighted financial fraud as a significant factor contributing to financial crises, posing threats to regulation, market liquidity, and the stability of capital markets. Such fraud aggravates market unpredictability and uncertainty, undermining investor confidence globally and impacting the overall economy. The rise in financial frauds necessitated the development of a specialized accounting branch aimed at investigating and revealing material inconsistency in financial reports, thereby exposing white-collar crimes associated with creative accounting practices. This led to the becoming known of **Forensic Accounting** as a critical tool for mechanism hidden irregularities and ensuring transparency in financial records.

METHODS OF FORENSIC ACCOUNTING

Two primary approaches have been developed to support forensic accounting: **Reactive Auditing** and **Proactive Auditing**.

1. Reactive Auditing

The reactive method focuses on detecting suspicious or unlawful activities to determine whether fraud has occurred. It also involves gathering evidence to support the fraud investigation and identifying the individuals responsible. This approach requires a systematic process, including recognizing, preserving, collecting, examining, and compiling the final findings. The key procedures in fraud detection under this method include:

- **Genetic Charting:** A tool that maps personal relationships among individuals directly or indirectly involved in the investigation (Crumbley, 2009).
- **Tracking Charting:** A method for visualizing cash flows between bank accounts or transactions from one company to another.

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- **Data Mining:** The use of computer systems to uncover hidden patterns or data (Mehta and Mathur, 2007).
- **Auditing Authority Delegation:** Reviewing the delegation of authority and identifying individuals involved in decision-making processes.
- **Authenticity Check of Financial Records:** Verifying the accuracy and credibility of the books of accounts.
- **Dispute Sequencing:** Documenting and analyzing the sequence of disputes and summarizing all relevant case details.
- **Expenditure Analysis:** Assessing the nature of expenditures to ensure proper capital allocation and identifying any diversion of funds between organizations.

This structured approach ensures thorough examination and helps forensic accountants uncover financial irregularities efficiently.

2. Proactive Auditing

Statutory Auditing is a form of proactive auditing that assesses the effectiveness of an organization's internal control systems to safeguard the interests of various stakeholders. It acts as a "diagnostic tool" to identify and analyze risks associated with potential fraud. Proactive auditing emphasizes maintaining organized and transparent accounting records, promoting ethical accounting practices within the organization.

Proactive auditing include:

- **Preventative Measures:** Establishing strong systems and controls to mitigating the risk of fraud.
- **Ethical Standards:** Promoting a culture of integrity and adherence to accounting best practices.
- **Diagnostic Function:** Acting as a tool to assess potential risks and address weaknesses in financial processes.
- **Stakeholder Protection:** Ensuring the interests of investors, employees, and other stakeholders are buffered.

By fostering an environment of transparency and accountability, proactive auditing helps organizations maintain financial integrity and build stakeholder trust.

Forensic Accounting in India:

Forensic accounting, which originated in the USA (United State of America) in 1995, began to gain propulsion in India only in recent years. The Institute of Chartered Accountants of India (ICAI) now offers a 100-hour certificate course to train Chartered Accountants and certify them as Certified Forensic Accountants (CFAs).

To combat financial fraud, the Government of India has established several agencies:

1. **Serious Fraud Investigation Office (SFIO):** Established in 2003, Operated under the Ministry of Corporate Affairs, SFIO investigates white collar crimes, and frauds in India.
2. **Central Vigilance Commission (CVC):** Established in 1964 this apex governmental body deals with corruption, the CVC has created a special "Forensic Cell" to address banking frauds under the supervision of the RBI.
3. **Central Bureau of Investigation (CBI):** Established in 1963, The CBI handles financial fraud cases through its "Economic Offence Wing."

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In addition to these government bodies, many private organizations in India are also providing forensic accounting services, contributing to the growing field of financial investigation and fraud detection.

CONCLUSION

Today, there has been a sudden increase in corporate fraud and scams, leading to an increase in white-collar crimes that are difficult to detect. Forensic accounting plays a vital role in addressing these issues, particularly in quantifying the economic damages caused by financial fraud. A growing concern in India is the rise of cyber fraud, which is expected to lead to more corporate scandals. To combat these malpractices, it is essential to establish a robust legislative framework for forensic accounting.

Moreover, specialized courses should be developed to enhance the understanding and implementation of forensic accounting techniques. Currently, forensic accounting is still in its early stages in India, and building a solid framework now will help prevent future frauds and errors. This will protect various stakeholders, helping to maintain their trust in the integrity of corporate entities. While auditing is an important tool for monitoring forensic accounting, further exploration in areas like data mining and the use of advanced computer tools is needed to enhance the effectiveness of forensic accounting.

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Conflict of Interest

The author(s) declared no conflict of interest.

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