Creative accounting and earnings management

Business, Accounting

Explain the meaning " creative accounting" and " earnings management". Creative accounting refer to the accounting practices that may follow the letter of the rules of standard accounting practices, but certainly deviate from the spirit of those rules. It also defined as the exploration of loopholes In financial legislation In order to gain advantage or present figures In a misleading favorable light, the creative accounting's task is to interpret the figure imaginatively, with the result that a largely fictional picture of events is often presented. They allow investors to compare the uncialhealthof competing companies.

However, when firms indulge in creative accounting they often distort the value of the information that their financial provide. Creative accounting can be used to manage earnings and to keep debt off the balance sheet. Earning management refer to the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position. Earnings Management takes advantage of how accounting rules can be applied and are legitimately flexible when companies can incur expenses and recognize revenue.

It can be difficult to differentiate these allowable practices from earnings fraud or manipulation. Earnings management theoretically represents this gray area, but it is often used as a synonym for earnings manipulation or earnings fraud. Question 2 Parapet(2000) came up with the idea that there are two types of earnings management, " good" and " bad" and it appears that there is a correlation between " bad" earnings management and thefailureof the companies. I. Describe the ; good" and the " bad" sides of earnings management. 1 . It help enterprise through a temporary financial crisis.

When the enterprise is in operation difficulty, and needed investment funds, often using profits push measures before. At this time, enterprise in general is in a poor financial situation, net assets yield rate cannot achieve match financing conditions due to high property debt, potential creditors credit support is not willing to provide. If confirmed later ahead of enterprise profit, be like, the straight-line method with accelerated depreciation, reduce the proportion of the loss of bad, delayed provision for impairment of long-term investment. Therefore, the current profits will be improved, so that the net assets yield to match demand.

At the same time, these practices can raise the rate of shareholders' equity, enterprise more easily through the debt way to raisemoney. Such, can help enterprise havefinancial difficulties, causes the enterprise to have plenty of money to fund the production and business operation activities. 2. To help enterprise to reduce the cost of contract. The surplus management can reduce the cost of contract. They think that the choice of accounting method with enterprise organization form and contracts the same Oromo, can reduce enterprise the contract between the parties costs, promote the minimization of enterprise value.

Considering the contract is incomplete, need to give operators certain accounting selection and treatment of flexibility on, in order to cope with the enterpriseenvironmentchanges and other unforeseen events. Especially in the peripheral environment changes affect the enterprise contract reference index, the enterprise management can through the proper surplus adjustments affect contract index, thus it can effectively avoid the costs or technical negotiation default cost, realize the minimization of enterprise value. Managers have certain of earnings management ability, to maintain effective contract is necessary.

But, this kind of earnings management on managers must not excessive opportunism behavior, not sedulous damage related interest group the interests of the premise. That is, by earnings management, is benefit to the enterprise development. 3. To help enterprise long-term development. In production and management for the instability of the enterprise, the implementation of the profit smoothing method, can deliver to the outside a production and business operation stability of information, strengthen the inference of investors for the enterprise, stable prices, and also help to shareholders to wealth minimization goal.

Take profits back measures is increasing year by year, make enterprise performance out of " growth" trend is increasing year by year, to set up the business enterprise operating performance of the steady growth of the good image, in order to attract more investors. Enterprise if can seize improve market share, turn " virtual growth" for " real growth", be helpful for setting up the enterprise image, the realization enterprise long-term developmentgoals. 4. It is to achieve the goal of tax planning. Modest earnings management can help enterprise reasonable, tax avoidance and tax planning.

It can not violate national tax policy, under the premise of not only reduce the tax burden on the enterprise, and at the same time and in conformity with the tax law contains the policy guidance. For enterprise, for example, it is a good choice. The bad sides of earnings management are: 1 . Reducing the financial statements the reliability of the information. When earnings management more than reasonable limit, it is easy to change for profit manipulation, making accounting information lose relevance and reliability.

And the correlation and reliability is the two fundamental accounting information quality characteristics. Among them, the reliability is a foundation, left the reliability, accounting and lost vitality. Earnings information is the most important accounting information, it is investors, creditors and external information users to evaluate the character of the enterprise is significant. Excessive surplus management make statements of the earnings of information become Numbers game, seriously will reduce the quality of accounting information, the reliability of the information lost financial statements. . To enterprise's development has some of the risk. Earnings management to a certain extent though can maintain the interests of the business operators and even enterprise, but also put in bigger risk. In fact, many enterprise surplus managementmotivationdid not give due consideration to the future development of the enterprise, and Just as an expedient sight. The company through the earnings management current profit increase, will make the expected goals profits becomes more and more big.

If no improving enterprise production and management activities, the next year if not reach the expected goal, in order to maintain enterprise image and company managers interests, and only more forcefully by earnings management, or even making illegal profits manipulation and accounting fraud, will eventually destroy the confidence of investors for the earnings securities news for investors a survey, and profit, earnings management in later turned back to will make investors disappointed. Performance of the company is not beautiful, will lead a stock value negative effects such as the downturn. . The local interest to damage the interests of the whole. Due to the economic interests of the enterprise management and investors, creditors ND the national interest in consistency, usually, earnings management to improve the management level of enterprises, but can't ignore management authorities in order to maintain their own economic interests and damage the investors, creditors and the country's economic interests of the facts. Excessive use of earnings management, because the local interest will damage the interests of the whole. Lie.

Discuss how Enron crossed the line from " good" to " bad" earnings management until the company collapsed on December 2001. Enron Corporation is one of the most innovative large company in America during sass. Enron was founded by Kenneth Lay the Chief Executive Officer (CEO) and McKinney & Co to assist in developing Enron's business strategy. By 2001, Enron had become a multinational corporation that owned and operated gas pipelines, electricity plants, paper plants, water plants and traded generally in financial markets for the same products and services.

Later, Jeffrey Shilling, who had a background in banking and asset and liability management had been appointed as a young consultant in Enron. The strategy introduced by Shilling had created comparative advantages in a long run to Enron over its rivals. In sass, Shilling hired Andrew Fast and he became Shilling protege where Shilling eventually made Fast being promoted as the Chief Financial Officer (SCOFF) of Enron.

As Enron's outside reputation grew, the internalcultureslowly began to take a darker tone, the stock price began to fall, Shilling suddenly resigned due to personal reason and the SCOFF Andrew Fast was fired. Under Factorsleadership, he used Special Purpose Entities (SPEC) in order to replace potential liabilities with assets and increase earning through income generated which enables Enron to maximize its benefits. However, Enron crossed the nine into fraud by entering into a series of transactions with SPEC that had no outside investor called Chew.