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CREATIVE ACCOUNTING PRACTICES AND THEIR ROLE IN COMPANY FAILURES

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Abstract

Background and Objective: Creative accounting refers to the manipulation of accounting standards and practices in ways that remain technically legal but distort the true financial position of a firm. While such practices may temporarily enhance a company's financial image, they often erode transparency, mislead investors, and increase systemic risks. **Study Design/Materials and Methods:** This paper examines the nature of creative accounting, its advantages and disadvantages, and its role in major corporate scandals, including Enron, Parmalat, Satyam, Toshiba, Lehman Brothers, and others. Through a qualitative case study approach, the research explores the mechanisms by which creative accounting evolves into fraud and corporate collapse.

Results: The case study analysis revealed that despite short-term benefits of creative accounting, it contributes to large bankruptcies and destabilises financial markets.

Practical implications: The findings suggest that while creative accounting provides short-term benefits such as increased valuations and capital inflows, it ultimately undermines corporate credibility, contributes to large-scale bankruptcies, and destabilises financial markets.

Conclusion and summary: The paper concludes by highlighting preventive measures, including stricter auditing practices, enhanced corporate governance, whistleblower protection, and forensic accounting techniques.

Keywords: creative accounting, earnings management, financial reporting manipulation, corporate governance, company failure

JEL classification: G41

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1. Introduction

Financial transparency is the foundation of modern capital markets. Investors, creditors and regulators depend on accurate financial reporting to assess the performance and stability of firms. However, the history of corporate finance is marked by cases in which organisations have distorted their accounts to project misleadingly positive images of profitability and growth. These practices are collectively known as creative accounting.

Creative accounting is not inherently illegal; it exploits ambiguities and loopholes in accounting standards to present financial information in a more favourable light (ALShanti et al., 2024). Yet the boundary between creative accounting and outright fraud is thin. Once managers manipulate figures to gain personal benefits, conceal liabilities, or inflate revenues, they cross from technical compliance into unethical or even criminal behaviour (Bachtijeva, 2021). The collapse of major corporations such as Enron, WorldCom, and Parmalat demonstrates how creative accounting can devastate investors, destabilise economies, and trigger regulatory reforms (Onyema et al., 2025).

This paper seeks to analyse creative accounting as both a technical practice and a systemic risk factor. It examines its techniques, advantages and disadvantages, followed by an exploration of major global scandals where creative accounting was central. Finally, the paper evaluates preventive and detection mechanisms aimed at safeguarding markets from manipulation.

The central research question is: How does creative accounting contribute to corporate scandals, and what mechanisms can mitigate its risks?

2. Literature Review

2.1. Defining Creative Accounting

Scholars define creative accounting as “the transformation of financial accounting figures from what they actually are to what preparers desire by exploiting accounting rules and/or ignoring some of them” (Abdurrahmani & Doğan, 2021; ALShanti et al., 2024). Unlike outright fraud, creative accounting operates in a grey area of compliance, where firms take advantage of subjective accounting judgments such as asset valuation, depreciation schedules, or revenue recognition (Blue et al., 2024; Al-Hamdani et al., 2024). Recent empirical reviews confirm that creative accounting remains a persistent global problem, driven by factors such as weak audit committees, executive incentives, lack of transparency, and regulatory loopholes (Cahyono et al., 2025; Hamed et al., 2024). Audit committee independence and effective disclosure practices are shown to reduce the incidence of manipulation, particularly in banking and financial institutions.

Bachtijeva distinguishes between earnings management and fraudulent reporting (Bachtijeva, 2022). Earnings management occurs when firms use judgment in financial reporting to influence perceptions of performance. Fraud, on the other hand, involves intentional misrepresentation and the violation of standards (Blue et al., 2025; Ifeoluwapo Adebimpe & Osarumwense Damian, 2024). Creative accounting lies at the intersection of these practices, where manipulation may be legal but deceptive. Technological advances now play a role in detection (Eulaiwi et al., 2024). Forensic accounting has been increasingly institutionalised as a preventive tool, while machine-learning models are emerging to flag anomalies in financial reporting (Alenazi et al., 2025; Onyema et al., 2025). Studies indicate that these computational approaches can improve early detection, though concerns remain about interpretability and reliance on black-box models.

2.2. Motivations and Consequences for Creative Accounting

The literature identifies several drivers:

- Capital Market Pressures – Companies often manipulate accounts to meet or exceed analysts' expectations (Blazek et al., 2023; Michulek et al., 2024; Onyema et al., 2025).
- Executive Incentives – Compensation structures tied to short-term earnings motivate managers to overstate profitability (Blazek et al., 2023; Hlawiczka et al., 2021).
- Financing and Credit Access – Firms engage in accounting manipulation to secure loans and attract investors (Abed, Hussin, Ali et al., 2022; Michulek et al., 2024).
- Political and Regulatory Pressures – In regulated industries, companies sometimes distort financials to influence taxation or compliance costs (Abed, Hussin, Haddad et al., 2022; Gupta & Kumar, 2020; Jarah et al., 2022).

While creative accounting may offer short-term gains, its long-term implications are overwhelmingly negative (Gagné & Hewett, 2025). The misrepresentation of earnings erodes investor trust, leads to inflated asset bubbles, and exposes firms to legal penalties (ALShanti et al., 2024). Furthermore, accounting scandals often trigger systemic crises, as seen during the 2007–2008 financial meltdown, where the misvaluation of mortgage-backed securities—facilitated by creative accounting—undermined global financial stability (Onyema et al., 2025).

2.3. Regulatory and Ethical Dimensions

The recurrence of corporate scandals underscores the inadequacy of existing controls. Studies emphasise the importance of corporate governance, audit independence, and ethical culture (Adejumo et al., 2025). Regulatory frameworks such as the U.S. Sarbanes–Oxley Act (2002) emerged as direct responses to accounting frauds, reinforcing the role of external audits and executive accountability (Ridzuan et al., 2024). However, scholars caution that regulation alone cannot eliminate creative accounting; instead, ethical leadership and transparent organisational cultures are essential (Odonkor et al., 2024). Regulators stress the need for stronger professional scepticism, better governance, and updated codes of practice.

In sum, creative accounting persists due to incentive misalignments, governance weaknesses, and evolving techniques. While detection technologies and forensic approaches show promise, ethical corporate culture and governance reforms remain critical for long-term mitigation.

3. Methodology

This research adopts a qualitative multiple case study approach to analyse the mechanisms through which creative accounting has contributed to corporate scandals. The qualitative design allows for an in-depth exploration of contextual and behavioural dimensions that cannot be captured through quantitative methods. A multiple case study approach, rather than a single case, enhances the robustness of findings and enables cross-case comparisons to identify recurring patterns, contextual differences, and systemic weaknesses in financial governance.

Cases were selected purposively to ensure diversity in geography, industry, regulatory environments, and in the nature of accounting manipulation. This heterogeneity strengthens the generalisability of insights while allowing an understanding of how creative accounting manifests under different institutional and cultural settings. The cases include: Enron (USA), Satyam (India), Toshiba (Japan), Lehman Brothers (USA), and Tesco (UK). The motivation to select such case studies is given in Table 1.

The study relies on secondary data including peer-reviewed academic literature, regulatory and audit oversight reports, court documents, and investigative journalism from credible financial press. These sources provide triangulation and enhance reliability by allowing multiple perspectives on each case.

Finally, the cases are compared to identify convergences and divergences in patterns of creative accounting across institutional contexts. The goal is to draw broader insights on how creative accounting evolves into scandal or failure, and to highlight what preventive mechanisms—including regulation, corporate ethics, and audit reforms—may mitigate such risks in the future.

Table 1. Selection of case studies

Enron (USA)	Chosen as a benchmark case in the literature on accounting scandals, Enron represents the archetype of creative accounting through complex off-balance-sheet financing, mark-to-market valuation, and audit failure. It highlights weaknesses in corporate governance and regulatory oversight in a mature capital market.
Satyam (India)	This case illustrates how creative accounting operates in an emerging economy context with evolving governance structures. The Satyam scandal demonstrates the role of weak internal controls, auditor complicity, and cultural dimensions influencing ethical decision-making in corporate reporting.
Toshiba (Japan)	Toshiba offers insights into creative accounting practices in a highly regulated, reputation-driven corporate environment. Its long-term profit inflation through accounting manipulation reveals how organisational culture, hierarchical management, and societal expectations can enable sustained financial misreporting.
Lehman Brothers (USA)	This case captures the intersection between creative accounting and systemic financial risk. Lehman's use of Repo 105 transactions to obscure leverage demonstrates how accounting creativity can amplify financial instability and contribute to global crises, providing lessons on regulatory blind spots in the financial sector.
Tesco (UK)	Tesco represents a more recent and retail-sector example where premature revenue recognition and supplier payment misreporting led to a major profit overstatement. This case reflects how creative accounting extends beyond traditional financial institutions, even within companies with strong governance frameworks.

Source: found by authors.

4. Findings and Case Analyses

4.1. Enron (USA)

Nature of manipulation. At Enron, the management used several sophisticated techniques: extensive off-balance-sheet entities (special purpose entities or SPEs), mark-to-market accounting for long-term contracts (allowing immediate recognition of projected future profits), and hiding liabilities and losses via structured transactions ("Raptors", etc.). These practices enabled Enron to inflate revenue forecasts, minimise visible debt, and present a misleadingly strong financial position.

Enabling factors / governance failures. In order to do this, there were some governance failures. First, aggressive executive incentives were tied to stock price and earnings. Second, there was weak board oversight - auditors failed in critical oversight and in some instances colluded with or insufficiently challenged management. And third, there were regulatory and accounting framework loopholes. This created legal but unethical latitude.

Detection / exposure. First, an internal whistleblower played a key role in alerting senior leadership and eventually the public. In addition, analysts and the media began investigating discrepancies and unusual accounting behaviour. And lastly came the collapse of market confidence when discrepancies became unmanageable, leading to bankruptcy in late 2001.

Consequences. This led to bancruptcy and massive losses for shareholders and pensioners. Also, a major regulatory reform occurred: the Sarbanes–Oxley Act (2002), one of the most significant in the U.S.

Lessons and literature connection. Enron is a textbook example of how creative accounting, even when it may be technically compliant with accounting rules, combined with poor governance and incentive misalignment, can lead to disaster. The literature confirms that such incentive pressures—especially when executive compensation is tied to short-term financial metrics—are potent drivers of accounting manipulation.

4.2. Satyam Computer Services (India)

Nature of manipulation. Satyam engaged in overstating revenues, inflating cash/ stock assets, under-reporting liabilities, and falsifying expense numbers. The CEO, Mr. Ramalinga Raju, admitted to creating fictitious assets and overstating profits over several years.

Enabling factors / governance failures. The audit committee had poor oversight, and auditors (including PricewaterhouseCoopers) did not detect irregularities despite clear warning signs. Moreover, very weak regulatory enforcement was exposed.

Detection / exposure. First, Raju's admission triggered the collapse. Second, public media investigations and regulatory investigations followed. And lastly, post default legal and forensic audits revealed the scope of manipulation.

Consequences. Due to this, investor confidence was lost, and executives and auditors received legal consequences. After this, many reforms to Indian corporate governance were introduced.

Lessons and literature connection. Satyam reinforces findings in the literature that governance structures (audit committees, board independence) are crucial. It also shows the role of forensic audits in detection and aftermath.

4.3. Toshiba (Japan)

Nature of manipulation. Toshiba overstated its operating profits by approximately US$1.2 billion over seven years. Techniques included booking future profits early, deferring losses (postponing the reporting of charges), and allocating costs inappropriately across divisions.

Enabling factors / governance failures. First, a culture of strict profit targets was set by top management, which pressured business units to meet unrealistic goals. Second, internal controls were weak; oversight by the audit committee / internal audit was insufficient. And third, auditor involvement and compliance issues; auditors were complicit or failed to challenge the estimates.

Detection / exposure. An independent third-party committee was established to investigate. The report was published in 2015. Moreover, there was media coverage and public scrutiny; regulatory authorities stepped in.

Consequences. Top executives including the CEO resigned, and significant reputational damage was done. Finally, corporate governance reforms in Japan were introduced: more emphasis on audit committee strength, outside directors, etc.

Lessons and literature connection. This case illustrates how corporate culture and top management pressure are major drivers of creative accounting. It aligns with the literature emphasising that non-technical factors (culture, incentive systems) are as important as the technical capacity to manipulate numbers. It also shows how detection and regulatory responses (when they occur) help curtail the damage, though often only after significant harm. Because Toshiba's scandal came somewhat earlier (2015), more recent comparative studies (e.g. Toshiba & Luckin Coffee, 2022) identify similar pressures and opportunities in newer scandals.

4.4. Lehman Brothers (USA)

Nature of manipulation. Lehman employed Repo 105 (and similar repo-transactions) to temporarily move liabilities off the balance sheet at quarter ends, thus improving leverage and liquidity metrics. These transactions were technically allowed under certain interpretations of GAAP (i.e. classified as sales rather than financing) if certain conditions were met. However, the substance over form was highly deceptive, since the repurchase obligations were almost immediate.

Enabling factors / governance failures. There was weak oversight by internal board and audit committees, and many transactions were not fully disclosed within internal governance frameworks. Furthermore, incentives were used to maintain the appearance of solvency. The last factor was the complexity of financial instruments and regulatory ambiguity regarding how to treat certain repurchase agreements.

Detection / exposure. Bankruptcy led to examiner reports that exposed the Repo 105 manipulations. Moreover, the media, rating agencies, and regulators identified inconsistencies.

Consequences. The collapse of Lehman was a pivotal event in the 2008 financial crisis; huge losses for creditors, and broad systemic risk. In addition, regulatory scrutiny intensified, including financial instrument accounting standards, risk disclosure, and leverage ratios.

Lessons and literature connection. Lehman underscores how creative accounting can be deeply embedded in financial institutions using structured transactions. It also demonstrates that compliance with accounting standards (literally) can still conceal dangerous risk. Recent literature underlines that the detection of such structural abuses often requires forensic audits plus regulatory oversight to inspect the substance rather than the form.

4.5. Tesco (UK)

Nature of manipulation. In Tesco's 2014 case, profit overstatements (later revised) were linked to how payments from suppliers were booked before the company had the right to receive them, artificially inflating profits.

Enabling factors / governance failures. There were weak internal controls over supplier accounting practices; internal audits did not detect the irregular timing of revenue recognition. Moreover, board oversight and audit committee effectiveness were questioned. And lastly, there was pressure to meet market expectations in a competitive retail environment.

Detection / exposure. External auditors and investigations. Moreover, media exposure and legal actions; investor lawsuits.

Consequences. Tesco received legal penalties, lost market value, and experienced reputational damage. They also pushed for stronger governance: improvements in internal controls and disclosure.

Lessons and literature connection. Tesco indicates that even in established regulatory jurisdictions with strong markets (UK), creative accounting can occur via "smaller" manipulations (supplier payments) rather than huge off-balance-sheet entities. The case aligns with literature on the importance of internal controls, audit oversight, and effective supplier/sales contract disclosure.

The analysis reveals that while the motivations for creative accounting—such as executive incentives and capital market pressures—are consistent, the methods vary across sectors. Enron used special purpose entities and mark-to-market accounting; Satyam inflated assets and profits; Toshiba deferred losses and overstated profits; Lehman Brothers used Repo 105 transactions; and Tesco misstated supplier contracts. Detection typically lagged, relying on whistleblowers, independent investigations, or post-crisis audits. Consequences included bankruptcies, fines, reputational damage, and systemic crises.

5. Discussion and Conclusions

From the cases, some cross-case patterns emerge. The findings indicate that creative accounting is facilitated by weak governance, aggressive incentive structures, and cultural pressures. Techniques differ, but the underlying motivations are aligned. Detection mechanisms such as forensic accounting, whistleblowing, and machine-learning tools show promise but require stronger integration into regulatory frameworks. Systemic risk highlights that regulatory responses often lag behind emerging manipulations. Preventive measures include independent governance structures, auditor independence, forensic audits, ethical culture, and the consistent enforcement of penalties.

Creative accounting operates in the blurred space between legality and fraud. While often technically compliant with accounting standards, it undermines the spirit of transparency and accountability, deceives investors, and destabilises markets. The case studies demonstrate how short-term benefits such as inflated share prices or access to financing quickly give way to long-term consequences: bankruptcies, regulatory fines, reputational collapse, and systemic crises.

The literature reviewed underscores that creative accounting persists due to persistent incentive misalignments, weak governance, and evolving regulatory loopholes. Advances in forensic accounting and machine-learning detection offer promising tools but must be integrated into regulatory and governance frameworks in order to be effective.

Ultimately, preventing the negative impacts of creative accounting requires more than technical compliance. It necessitates cultivating ethical corporate cultures, ensuring robust governance, protecting whistleblowers, and enforcing accountability at all levels. By addressing both structural and cultural enablers, regulators and firms can move closer to financial reporting systems that genuinely reflect economic reality, thereby restoring and maintaining public trust in markets.

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