The Thin Line Between Cosmetic Accounting and Fraud: Legal Loopholes Exploited by Corporations

Prof. Somesh Kumar Shukla[1], Shruti Agrawal[2]
[1]*Professor, Department of Commerce, University of Lucknow*
[2]*Research Scholar, Department of Commerce, University of Lucknow*

***Abstract*—This study explores how cosmetic accounting, though permissible but immoral, gradually shifts into accounting fraud when managerial intent, materiality and misrepresentation increase. The purpose of the research is to understand this thin boundary and identify when legitimate accounting becomes deceptive. Using a qualitative, descriptive and exploratory approach based on secondary sources such as Companies Act provisions, SEBI Regulations, Indian Accounting Standards (Ind AS) and past fraud cases, the study analyses key differences between cosmetic and fraudulent practices and highlights the role of auditors, regulators and governance failures. The findings conclude that weak oversight, audit lapses and regulatory gaps allow cosmetic accounting to escalate into fraud, emphasizing the need for stronger SOPs, auditor independence and stricter enforcement to ensure transparency and financial reporting integrity.**

***Index Terms*—Cosmetic Accounting, Accounting Fraud, Financial Reporting, Manipulation and Misrepresentation**

I. INTRODUCTION

In an increasingly complex global financial landscape, the reliability of corporate financial statements is paramount to ensuring transparency, investor confidence, and the integrity of capital markets. However, the boundaries between lawful financial reporting practices and misrepresentation are often blurred by a phenomenon known as cosmetic accounting. This involves the strategic manipulation of accounting information within the framework of accounting standards but outside their ethical spirit to present a more favourable and attractive view of a company's financial position than is warranted by its actual performance.

Cosmetic accounting is the practice of manipulating financial statements and reporting to present a more favourable picture of a company's financial position and performance. It is often used interchangeably with terms such as "creative accounting," "big bath accounting," "window dressing," and “misrepresentation” all of which describe the use of accounting techniques to improve a company's financial appearance without actually improving its underlying financial performance. This practice is fundamentally about leveraging professional judgment and the inherent flexibility within accounting principles, regulations and organisational policies. Instead of falsifying records, practitioners of cosmetic accounting achieve their desired financial outcomes by making specific choices from a range of acceptable accounting methods, estimates, or reporting rules allowed by applicable regulations. The goal is to influence stakeholders by portraying a desired financial standing, for example, by smoothing a company's income stream to reduce fluctuations and give the appearance of stability.

Fraud is the deliberate use of false representations to gain unjust advantage and criminal deception. Corporate frauds, conceptually, is broad and encompasses a variety of criminal and civil violations. Section 447 of the Companies Act, 2013, is the punitive core of the anti-fraud framework. It defines "fraud" in a broad and inclusive manner, encompassing "any act, omission, concealment of any fact or abuse of position".

According to Contract Act, 1872 “Fraud” means and includes any of the acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party or his agent, or to induce him to enter into the contract.

Several theoretical frameworks provide insight into why organizations or individuals engage in fraudulent behaviour. Three primary theories have been proposed to explain the causes of fraud:

(1) The Fraud Triangle- The fraud triangle is a framework commonly used in auditing to explain the reason behind an individual's decision to commit fraud.

(2) The Fraud Diamond- To improve both fraud prevention and detection, a fourth element considers in fraud diamond theory which is an individual's capability.

(3) The Fraud Pentagon- states that the five factors in fraud pentagon have simultaneous and significant effects on fraudulent financial reporting.

Cressey examined the first theory of fraud in 1953, where Cressy establishes a link between fraud and human behaviour. Cressey analysed three conditions that can lead to fraud in his 'fraud triangle theory' these key elements are: pressure, opportunity, and rationalization which can be seen in some corporate cases like Parmalat, Satyam, Yes Bank. The Fraud Triangle theory remains a fundamental framework for understanding financial and corporate fraud. While older, high-profile cases like Enron and WorldCom are often cited, the theory is consistently applied to more recent scandals to provide a clear and concise explanation of the motivations and circumstances behind them.

Building on this, the fraud diamond introduces a fourth element capability or competence as a contributing factor. The most recent development is the fraud pentagon theory, introduced by Crowe Horwath in 2011, which adds a fifth element: arrogance. This factor refers to the attitude of individuals who commit fraud by disregarding company rules and policies, often due to their belief in their own superiority or position of power (Gupta & Kumar, 2020). According to Horwath (2011), a study by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) found that 70% of fraudsters exhibit a combination of pressure and arrogance or greed, and that CEOs are involved in 89% of fraud cases (Yusof, Khair, & Simon, 2015). The notorious Bhushan Steel scam, for instance, perfectly illustrates these theories in action, where the Serious Fraud Investigation Office (SFIO) found a "massive exploitation of the corporate structure" by promoters who operated the listed company "more like a proprietorship concern," highlighting the variables of arrogance and opportunity.

The penalties for such transgressions are severe. Under the Companies Act, 2013, a person found guilty of fraud can face imprisonment for a term of at least six months and up to ten years, along with a fine that can extend to three times the amount involved in the fraud. For frauds involving public interest, the minimum imprisonment is three years.

The distinction between Cosmetic Accounting and Accounting Fraud is not always clear and is the very essence of the "gap" in question. The transition from one to the other is not a single, instantaneous leap but a subjective spectrum where the tipping point is defined by intent, legality, and materiality.

Cosmetic accounting may be both intentional or innocent, irregular or misfeasance but fraud is always intentional.

II. LITERATURE REVIEW

The literature on financial reporting manipulation spans diverse themes such as cosmetic accounting practices, fraudulent financial reporting, behavioural theories explaining fraud, and the regulatory environment governing corporate disclosure. Earlier cosmetic accounting identified as the strategic use of flexibility within accounting standards to influence financial perceptions without explicitly violating legal norms. According to Copeland (1968), "Cosmetic accounting involves the deliberate and repetitive selection of accounting treatments or measurements in a specific pattern, with the intent to present financial statements, particularly income figures, with reduced fluctuations, thereby creating an appearance of consistency and stability that may not reflect the true economic reality." Amat and Blake (1999) describe creative accounting as the transformation of financial numbers from what they actually are to what preparers desire, while maintaining compliance with accounting rules. This view is expanded by Mulford and Comiskey (2002), who emphasise that cosmetic accounting relies on managerial judgment regarding timing, classification, and estimation to present a deliberately biased financial position. However, several authors highlight that cosmetic accounting may serve as a precondition to accounting fraud. Jones (2011) suggests that firms initially engage in earning management to achieve market expectations, which can escalate into fraudulent behaviour when performance pressures intensify. This progressive continuum between earnings management and fraud is further supported by Perols and Lougee (2011), who argue that fraud firms often exhibit aggressive accounting patterns for years before fraudulent intent become visible.

Recent studies evaluate fraud detection using quantitative models. Naomi Clara Situngkir (2020), tested the fraud pentagon theory to detect fraudulent financial reporting using the fraud score model of companies listed in Indonesia Stock Exchange in 2014-2018. It was found that fraud pentagon theory affects the fraudulent financial reporting but it can be used to minimize the occurrence of fraudulent financial reporting by ensuring the fairness of a financial report and assessing the risk of fraud by taking into account all aspects, especially if there any changes in the financial ratios occur. Kaseem and Higson (2012) examined the evolution of fraud theory in his paper "The New Fraud Triangle Model", highlight that organisational culture and external pressures significantly shape fraudulent tendencies, suggesting that fraud theories must account for contextual variability.

A significant body of literature examines how regulatory and governance structures influence financial manipulation, emphasising that complex accounting standards, weak enforcement capacity, and structural gaps in audit oversight enable irregularities. In India, although SEBI's LODR framework and the Companies Act, 2013 aim to improve transparency, enforcement challenges continue to undermine their impact. Post-Satyam reforms strengthened governance norms, yet Narayanaswamy (2010) observes that monitoring remains inconsistent. The creation of National Financial Reporting Authority (NFRA) in 2018 enhanced independent audit supervision, but concerns over auditor independence persist. Evidence from Krishnan and Krishnan (1996) shows that economic bonding through long auditor tenure, fee dependence and non-audit services compromises objectivity, while DeFond and Zhang (2014) argue that auditor–client incentives weaken reporting quality in weakly regulated environments.

Overall, existing literature highlights the inherent flexibility of accounting standards, behavioural drivers of manipulation, and weaknesses in regulatory enforcement. However, limited researches are included to clarify conceptual and operational boundary of each dimension between cosmetic accounting and fraud. There are few studies which examine how discretionary accounting choices transform into deliberate illegal fraud within the Indian regulatory framework.

III. RESEARCH METHODOLOGY-

This study adopts a qualitative, descriptive, and exploratory research design to examine the conceptual distinction between cosmetic accounting and accounting fraud, as well as to analyse when a cosmetic accounting practice turned into accounting fraud. The research primarily based on secondary data sources, including various journal articles, company financial statement, government reports. Companies Act, 2013, SEBI (LODR) Regulations, and relevant accounting standards (Ind AS), along with an institutional analysis of the roles of regulatory bodies are also considered to interpret.

A. Research objectives

1. To examine the conceptual difference between cosmetic accounting and accounting fraud.
2. To study case examples where cosmetic accounting turned into accounting fraud.

B. Research Questions

To find out the above-mentioned research objectives, this study seeks to answer the following questions:

1. When a cosmetic accounting turns into accounting fraud or when a legitimate accounting converts into illegitimate accounting?
2. What policy reforms may be required to mitigate the misuse of accounting flexibility and strengthen financial reporting integrity?

C. Legitimate Accounting

Legitimate accounting refers to the faithful, transparent and law-biding application of Accounting Principles, Accounting Standards and Regulations to record, classify and present financial information. It aims to give a true and fair view of a company's financial position and performance to stakeholders. In legitimate accounting, disclosure is complete, accurate and complies with applicable standards.

D. Illegitimate accounting

Illegitimate accounting involves the deliberate misuse, manipulation, or falsification of Accounting Standards, Principles or Records to mislead stakeholders about a company's financial position. This may start as aggressive accounting but becomes fraud when intent is deceptive. In illegitimate accounting-

Revenues may be inflated or fabricated.
Expenses and liabilities are hidden, understated or shifted to another period.
Assets are overstated through false capitalization, valuation manipulation or non-disclosure.
Misrepresentation of accounting records.

Table 1 Difference between Cosmetic Accounting and Accounting Fraud

Basis	Cosmetic Accounting	Accounting Fraud
Meaning	Use of flexibility within accounting standards to present financial results in a more favourable way.	Deliberate falsification or misrepresentation of financial records to deceive stakeholders.
Legality	Operates within the legal framework though ethically wrong.	Illegal and punishable under corporate, civil and criminal laws.
Intent	To makeup or "window-dress" accounts and make performance appear better than it actually is.	To cheat, conceal or mislead stakeholders for financial or personal gain.
Techniques used	Cosmetic accounting techniques include aggressive revenue recognition, deferring expenses, asset misappropriation, etc.	It includes techniques such as fictitious sales, hiding liabilities, inflating assets, forging documents, round tripping.
Nature	Ethically wrong but legally permissible.	Both ethically and legally wrong.
Law	Falls within the boundaries of law, as it uses options allowed by Ind AS, Companies Act and SEBI norms.	It Violates law and attracts criminal prosecution, penalties, imprisonment, and director disqualification (section 447 & 448 of Companies Act, 2013).

(Source: Author's own compilation)

IV. SEBI OBLIGATIONS REGARDING TRANSPARENCY IN CORPORATE REPORTING

The Securities and Exchange Board of India (SEBI) plays a crucial role in ensuring corporate transparency, accountability and investor protection in India. In September 2015, SEBI introduced the Listing Obligations and disclosure Requirements (LODR) Regulations as part of its ongoing efforts to enhance governance practices and harmonize the listing obligations of listed entities with international best practices. In which, firms are required to disclose quarterly and annual financial results, audited in accordance with Indian Accounting Standards, along with segment-wise performance and cash flow statements. The SEBI LODR mandate came into effect on December 1, 2015 and after that it has undergone multiple amendments to stay relevant and adaptable to the dynamic financial environment. In 2018-2019, SEBI implements amendments focusing disclosure of related party transactions and CEO pay ratio. In 2021, SEBI introduces disclosure of Environmental, Social and Governance (ESG) and in 2023, SEBI further strengthens compliance for related party transactions, disclosure of material events to top 1000 companies listed on stock exchange.

The SEBI LODR Regulations, 2015 aim to ensure that listed companies maintain good corporate governance and regularly share important information with their shareholders and the public. This helps investors make informed decisions and promotes transparency in the market. The regulations cover various aspects like board composition, financial reporting, disclosure of important events, related party transactions, and shareholder rights. They apply to all companies listed on recognized stock exchanges in India. The LODR framework draws heavily from the Companies Act of 2013 and includes guidelines from international regulatory practices such as the Sarbanes-Oxley Act (SOX) of the United States.

The Yes Bank vs. SEBI (2021) case dealt with the accuracy of financial disclosures. Yes Bank had understated its non-performing assets (NPAs) in its financial statements, which SEBI found to be a violation of the LODR Regulations. The LODR Regulations have significantly improved corporate governance practices in Indian companies.

Disclosure requirements under the SEBI LODR Regulations 2015 have a direct impact on market efficiency. Efficient markets need information to be quickly and equally available to all participants. Corporate governance disclosures help investors assess the quality of company management and board oversight. Companies with stronger governance structures often enjoy higher valuations due to lower perceived risk.

Table 2 Accounting Standards and their scope for manipulation in cosmetic accounting

Accounting Standard	Provision/Flexibility allowed	Scope for constructing of cosmetic accounting	When cosmetic accounting practices turned into accounting fraud
Ind AS 2- Inventory Valuation	Inventory valued at cost or NRV (whichever is lower); choice of method such as FIFO, LIFO, Weighted Avg.	Use of favourable method to smooth profits.	Phar-Mor (USA) overstated inventory by $1 billion to hide the company's true financial losses.
Ind AS 5- Revenue Recognition	Revenue recognized when goods are transferred; estimates vague definitions of "delivery".	Recording sales early, inflate revenues before actual delivery.	In Ricoh India case 2016, an internal investigation found that company's financial statement had altered in order to inflate revenues and profits which causes loss of Rs 1,123 crore for the fiscal year ended March 31, 2016.
Ind AS 16 – Property, Plant & Equipment	Choice of depreciation method, estimation of useful life and residual value of asset.	Companies extend useful life of asset to reduce depreciation expense and inflate profit.	Satyam (2009) showed fictitious assets and appreciated assets by 1.47 billion.
Ind AS 36- Impairment of assets	Judgement in calculating recoverable value; cash generating unit estimations	Avaoiding impairment, inflating asset values	Toshiba (2015) overstated profits for seven years by deliberately avoiding the impairment of loss-making assets which results in a $1.2 billion accounting scandal.
Ind AS 37- Provisions & Contingent Liabilities	Provisions are based on best estimate; contingent liabilities disclosed not recognized.	Company may inflate profit through under provisioning and over-provisioning to create reserves.	AIG (2005) deliberately created excess reserves and overstated profit by more than $3.9 billion. Used sham reserves to smooth earnings.
Ind AS 38- Intangible assets	Capitalization of development costs with managerial judgement	Capitalizing expenses to reduce operating costs	WorldCom (2002) capitalizes routine operating expenses as intangible assets which resulted $3.8 billion of expenses were wrongfully capitalized.

(Source: Author's own compilation)

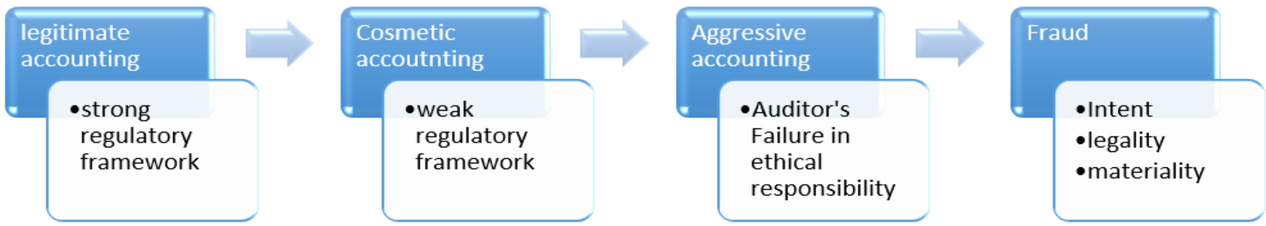

Figure 1. Process of Accounting- Cosmetic to Fraud

The transition from legitimate accounting to fraud typically occurs through a gradual and sequential process in which each stage coordinates higher levels of manipulation. Here we can understand this process through diagrammatic representation.

As shown in figure 1 Legitimate accounting involves the fair and faithful application of accounting standards. However, companies may adopt cosmetic accounting to meet performance expectations of investors, stakeholders within the framework of law. When this superficial manipulation is insufficient, firms may escalate to aggressive accounting, where management stretches accounting standards, exploits estimation flexibility or applies overly optimistic assumptions to inflate profits or defer losses. At this stage all type of audit such as government audit, independent audit, regulatory audit, auditors failed to detect fraudulent activities as the boundary between legal and illegal accounting becomes blurred. Management manipulates with auditor and consistently persistent pressure and weakened ethical judgement can lead to fraud which contain three main constructs i.e., Intent, Legality, and Materiality as the Tipping Point.

The most critical differentiator is the presence of Intent to deceive. While both practices involve intentional manipulation, fraud is defined by the specific purpose of misleading stakeholders for private gain. For example, using accounting judgment to defer a legitimate expense (cosmetic accounting) is distinct from creating entirely fabricated transactions to inflate revenues (fraud). The former may be aggressive, but the latter is a clear act of deceit.

The Legality of the action is the second key element. Cosmetic accounting exploits the flexibility of legal rules; it does not explicitly violate them. In contrast, accounting fraud involves a direct and deliberate violation of established accounting standards and laws, such as altering records or intentionally omitting required disclosures.

Finally, the concept of Materiality is central to a legal determination of fraud. A misstatement must be significant enough to potentially influence an investor's decision. While a minor, non-material misstatement could be an aggressive accounting practice, a large-scale, material misstatement is often the basis for a fraud claim. The presence of a deliberate plan to conceal a misstatement from auditors or regulators is also a strong indicator of fraudulent intent.

V. FINANCIAL REPORTING DISCLOSURE

Financial reporting disclosure refers to the process of presenting relevant, accurate, and complete information about a company’s financial position, performance and operations to stakeholders through financial statements. It ensures transparency, and accountability by providing details beyond the basic numbers in balance sheets, income statements and cash flow statements. Disclosures typically include accounting policies, contingent liabilities, related party transactions, segment reporting, etc. These disclosures are guided by statutory requirements, accounting standards and regulatory frameworks like SEBI or the Companies Act, 2013. The primary objective of financial reporting is to reduce information asymmetry between management and stakeholders, enabling investors, creditors, regulators and the public to make informed decisions.

VI. CONCLUSION

The present study clearly brings out that cosmetic accounting, though often defended as legitimate managerial choice within the flexibility of accounting standards, gradually develops into a serious threat when its intent shift from temporary presentation benefits to deliberate manipulation of financial reality. The paper underlines that the thin line separating cosmetic presentation from fraudulent misstatement lies primarily in intent, materiality, and the impact on stakeholder's economic decisions. While regulatory frameworks such as the Companies Act, SEBI (LODR) Regulations, and Ind AS attempt to restrict excessive managerial discretion, the persistence of loopholes, ambiguous disclosure norms, and limited enforcement allows corporations to exploit grey areas with ease.

The case insights discussed in the paper demonstrate that cosmetic accounting does not occur in isolation; rather, it is supported by weak governance structures, ineffective oversight mechanisms, audit failures etc. hence, strengthening financial reporting cannot fulfil all requirements it also requires ethical commitment, regulatory vigilance, auditor independence, internal control, etc. The study concludes that the thin line between cosmetic accounting and accounting fraud both originate from the same set of discretionary choices. It is only the underlying intention and the degree of misrepresentation that distinguish between them. Therefore, bridging this gap demands stricter enforcement, enhanced accountability of preparers and auditors, and strong government framework.

VII. SUGGESTIONS

1. Standard operating procedures (SOPs) should be created for all major judgement-based accounting areas such as revenue recognition, provisioning, asset valuation and impairment. Clear and uniform SOPs will minimise ambiguity and restrict excessive managerial discretion, thereby reducing the scope for cosmetic accounting.
2. Independent auditor norms and standards should be strengthened so that auditors cannot be influenced or managed by company management. Measures such as stricter rotation, limits on non-audit services, stronger NFRA supervision and transparent reporting of audit concerns will enhance auditor independence and reduce the risk of manipulation. Selection of Auditor should not be at the discretion of businessman/ corporate boards/ companies' owner. Government agency should have a panel of CA firm, which is ranked based on resources such as partners, paid staff, technology, tools and experience. There should be mandate physical verification of all the documents provided by management and the opinion given by the auditor should not be rely only on managements information.
3. If a company wants to get itself audited, then it should enter basic details (revenue, profit, assets, etc.,) in the Government Agencies portal which based on the size of the Company and appropriately ranked firm should be auto allocated. The fees shall be determined and recovered by the Govt. agency and not be directly billed by the Auditor firm on the client. The Govt. agency shall also have a Quality Assurance team to oversee the quality of the Audit reports and supporting evidence. The QA would pick up sample of audits each year and assess to see whether audit report was accurate or not.
4. Internal governance and oversight mechanisms need to be reinforced by empowering audit committees, improving the quality of internal audit and adopting continuous monitoring systems. Boards and independent directors must play a more active role in evaluating accounting assumptions and estimates rather than relying solely on management explanations.
5. Regulatory bodies such as SEBI, NFRA and MCA require stronger enforcement capacity through better technology, real-time analytics and faster adjudication. Timely action and stricter monitoring will discourage prolonged misuse of accounting flexibility and limit the transition from cosmetic accounting to fraud.
6. A structured and continuous information-sharing mechanism between auditors and regulators should be introduced so that suspicious accounting patterns, repeated inconsistencies or aggressive estimates are reported at an early stage. Such coordination will help detect potential fraud before it becomes material.
7. To prevent defective book-keeping system, Companies need to maintain real time transaction in related party transactions from a single code. Incomplete documentation should be avoided and the rules and regulations which is provided by Accounting Standards (AS), Indian Accounting Standards (Ind AS), International Financial Reporting System (IFRS), Income Tax Act 1961, Companies Act 2013, should be uniform at same level of company.

REFERENCE

[1] Cressey, D. R., "The criminal violation of financial trust," *American Sociological Review*, vol. 15, no. 6, pp. 738–743, Dec. 1950.

[2] Cressey, D. R., *Other People's Money: A Study of the Social Psychology of Embezzlement*. Glencoe, IL, USA: Free Press, 1953.

[3] Copeland, R. M., "Income smoothing," *Journal of Accounting Research*, vol. 6, pp. 101–116, 1968.

[4] Amat, O., J. Blake, and J. Dowds, "The ethics of creative accounting," *Economics Working Paper*, no. 349, pp. 715–736, 1999.

[5] Mulford, C. W., and E. E. Comiskey, *The Financial Numbers Game: Detecting Creative Accounting Practices*. Hoboken, NJ, USA: John Wiley & Sons, 2005.

[6] Perols, J. L., and B. A. Lougee, "The relation between earnings management and financial statement fraud," *Advances in Accounting*, vol. 27, no. 1, pp. 39–53, 2011.

[7] Crowe, H., "Why the fraud triangle is no longer enough," Horwath, Crowe LLP, 2011.

[8] Jones, M. J., *Creative Accounting, Fraud and International Accounting Scandals*. Hoboken, NJ, USA: John Wiley & Sons, 2011.

[9] Kassem, R., and A. Higson, "The new fraud triangle model," *Journal of Emerging Trends in Economics and Management Sciences*, vol. 3, no. 3, pp. 191–195, 2012.

[10] Yusof, M. K., A. Khair, and J. Simon, "Fraudulent financial reporting: An application of fraud models to Malaysian public listed companies," *The Macrotheme Review*, vol. 4, no. 3, 2015.

[11] Situngkir, N. C., and D. N. Triyanto, "Detecting fraudulent financial reporting using fraud score model and fraud pentagon theory: Empirical study of companies listed in the LQ 45 Index," *The Indonesian Journal of Accounting Research*, vol. 23, no. 3, pp. 373–410, 2020.

[12] Nurcahyono, N., and A. N. Hanum, "Perspective of the Pentagon Fraud Theory," in *Proc. 1st Lawang Sewu International Symposium on Humanities and Social Sciences (LEWIS 2022)*, vol. 758, Springer Nature, pp. 163–169, Jun. 2023.

[13] IRIS Business Services, "An in-depth look at SEBI's Listing Obligations and Disclosure Requirements (LODR) mandate."

[14] *The Indian Contract Act, 1872*. Government of India, 1872.

[15] Government of India, *The Companies Act, 2013*. Ministry of Corporate Affairs, 2013.