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Review Paper

Creative Accounting: Developing A Model

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Abstract

The purpose of this paper is to understand the concept of creative accounting well, to differentiate between earnings management and fraud, for which literature review has been thoroughly analyzed. Model has been developed, which demonstrates the parties i.e. Banks, Auditors, Investors, Regulatory authorities etc. that are involved in creative accounting. Accounting professionals take advantage of the loopholes in the accounting regulations to manipulate accounts. Creative accounting can be done either "Beyond the Regulatory requirements" or "Within the Regulatory requirements". This study suggests that Manipulations can be controlled by the effective implementation of Corporates' internal control systems, compliance with codes of corporate governance and meeting the financial reporting regulatory requirements.

Keywords: Creative accounting, earnings management, regulatory authorities, accounting regulations and corporate governance.

Introduction

In the world of increased competition, it is necessary for the firm to value its stakeholders as they are important asset for the firm. They need the exact information about the company. Since the history's worst bankrupt of the famous companies like Enron, WorldCom, Xerox and A hold Royal etc. they have created an atmosphere of mistrust and lack of confidence on firm for its stakeholders. Creative accounting was the driving force behind that where accounting professionals used their skills and abilities to manipulate the accounting figures that have resulted in misinterpretation of the information to the stakeholders. Accounting professionals used different techniques to manipulate the accounting figures i.e. income smoothing, big bath accounting and window dressing. The significance of creative accounting cannot be denied as it either provides solutions for problems or create problems for a company. That depends on its very usage, in most cases creative accounting has been negatively used to manipulate the accounting figures in order to create a desired image. Accounting professionals took advantage of the loopholes in accounting regulations. Luca Paciolo was the founder of accounting so the first practice of creative accounting belongs to him. The concept of altering accounting figures is as old as 500 years. Creative accounting becomes popular in 1980. Because of the flexibility in accounting rules, accounting professionals took advantage of that, they manipulated accounting figures to get the desired results[1].

Naser[2] defines creative accounting as a process in which accounting figures are manipulated by the accounting professionals from their real state to the faked state with the help of the loopholes in the accounting regulations. Bad governance gives the opportunity to manipulate the accounting figures. The methods of creative accounting can be categorized, as there is no specified accounting method that a company should use. Company simply adapts that method which is more beneficial for it. For example company is given permission to select the policy of witting off Research and Development expenditure as it arises and repaying it in the life of related project. There is a chance to include the false transactions to alter balance sheet in order to show the high profit in the different time periods generally involving a bank. True transactions are carried out to give the anticipated image in accounts. According to Wells[3] and Lord[4] fraud consists of a false representation of statement to cheat other, an evidence that the victim has been influenced by the false statement, and consequences that victim has to face after relying on those false statements.

Earnings management varies from fraud as fraud is not in the boundary of generally accepted accounting principles (GAAP) fraud exists when somebody obliges an unlawful action. While, earnings management lies in the boundary of GAAP and it is a method of accounts manipulation. Manipulation is not cheating. It is a subject of understanding. Earnings management constitutes a diversity of legal and illegal acts performed by management that impacts earnings of a firm. Illegal acts may include the recording of a transaction and other proceedings in the incorrect accounting period or the incorrect documentation of fabricated transactions both are cheating. Earnings management does not break up the standards of accounting, yet it misguides the investors about the performance of the company.

The ratio of fraud is higher in those companies which were not involved in earnings management before but still they were unable to produce the results according to the expectations of the analyst. The Auditors face difficulties in differentiating between earnings management and fraud as there is no appropriate method available. It is difficult for Auditor in identifying earnings management and researchers also have problem while defining the motivations of earnings management. It is said that Earnings management and fraud differs from each other because of the contract with principles[5].

Kellogg and Kellogg[6] demonstrate two motives behind manipulation: to attract investors towards company and to enhance the market value of a company. Earnings shown by Accrual and cash accounting methods differ in terms of time as in a long run the earnings shown by both methods are same while in the short run there are differences when revenues are matched with expenses. There is a method to deal with these differences. Earnings management is a technique of dealing those differences; it shows the profit in the needed year while keeping the expenses aside. It is an illegal action performed by hoping that profit would improve later and the overdue expenses will be shielded. Management uses the loopholes in law to create a desired image of the company, or companies achieve the financial performance by manipulating earnings by the identifications of lags in law.

Mine OmurgonulsenandUgurOmurgonulsen[7] have raised the problem of earnings management regarding lawful and unlawful aspects considering its importance for companies. They study the creative accounting practices particularly Turkish case of Imar Bank.

Baruch[8] identified in his study that the key participants that have enough information about the company include management, auditors and financial experts, all of these are not worried by the present exposure of intangible assets rather they are worried about non-exposure. The rapid shift of research and development whether done from inside, or obtained, on costs, is a procedure for enrichment of growth of stated profits. The major frauds of the accounting history like Enron, WorldCom and Tyco had got the attention of the world in 2002. After these scandals, improved accounting regulations and audit system was required. Initially, Securities and Exchange Commission and public accounting profession took notice of Enron Crisis. Unlikely, in 1970s and 1980s significance of financial disasters, the major parties like investors, creditors, legislator and workers of Enron took the notice of it late. Presently states are facing financial crisis which encourages them to interfere in saving the financial institutions (Banks).

In the above situations, role of auditor has been questioned. Financial Institutions were bankrupt after they receive the unqualified opinion. For Example Bear Stearns was given unqualified opinion on 28 Jan 2008 and in the March, it has faced financial problems. There are various motivations behind creative accounting like the tax tariffs on income, encouragement from shareholders and employees to show stable earnings and the impact of psyche on the increase or reduction of income.

The aim of this paper is to understand the concept of creative accounting well, to differentiate between earnings management and fraud, to develop a model demonstrating the parties that are involved in creative accounting, what are the different techniques used by them and to suggest the measures that reduce the practice of creative accounting.

Literature review: In 1970s, Anglo Saxon was the first person to write about creative accounting in terms of the frauds in various companies. Watts and Zimmerman[9] wrote positive about creative accounting. After that a lot of work has been done on creative accounting to show its importance and the political cost that company has to face. Trotman[10] explained creative accounting as a technique to show the better side of the information to the investors. So, that information is being filtered in such a way that it gives a good image of the financial position of a firm to the investors. As a Practitioner, Jameson[11] explains that the creative accounting is within the limits of law, it follows accounting standards, and thus it obeys the law but not its essence. Therefore, he sees creative accounting in a negative sense that misrepresents the users about accounting information. As a financial analyst, Smith[12] states that the raising growth in 80s was not real in fact it happened because of the accountant's creative accounting practices. Merchant and Rockness[13] states that the misrepresentation of income is beneficial for the company in short term but in the long term it negatively impacts its economic steadiness. Shah[14]and Mac Barnet and Whelan[15] describe that the techniques used to manipulate the figures to produce the anticipated image is known as the tools of creative accounting. After one year, Shah[14] explains that managers took advantage from the loopholes of the accounting standards to manipulate accounting figures. The author also stress that creative accounting obeys the law but not its essence.

Stolowy and Breton[16] used various terms for creative accounting such as earnings management, income smoothing, big bath accounting, accounts management and window dressing. These terms show the different approaches that are selected by accounting professionals for various reasons.

Ramaswamy[17] states that the recent crisis faced by the companies due to creative accounting has disturbed the truthful presentation of financial statements. According to Usureluet al.[18] ethics should be followed by the accountants. They also discussed about the ethics of national code for Romania's accountants. Rabin[19] demonstrates auditor's behavior and approach towards creative accounting. According to him individual's own nature, code and policy of organization determines the ethics of auditor. For a quality audit, auditor should possess elements of understandability, relevance and reliability.

Cosmin[20] identified the various techniques used by the accounting professionals to manipulate results. First one is Tangible Assets in which "Subjective depreciation" of assets creates room for creative accounting. When the management feels that the recovery value of assets is less than the actual value. The outcome will be affected by recording a depreciation expense. Goodwill increase by undervaluation of assets purchases capitalization and depreciation. It would impact the results of the next year as well. Depreciation has great influence on the profit and loss of an asset life. The different methods show different disbursement. Inventories also leave space for creative accounting. The increase/decrease in stock impacts the present as well as next year's financial statements.

Ellisabeta and Beattrice[21] associated agency theory with creative accounting, as agency theory arises due to the conflict of the interest of users. There is also a conflict of interest between the users of accounting information.

Shah et al.[22] demonstrated that in the presence of strict rules and regulations in accounting how managers get success in creative accounting. They also explore whether creative accounting helps the company or land them into crisis. They explained it with the example of Enron, how the most profitable company ended bankrupt. It is also explained that how the balance sheet items such as assets and liabilities are used to get the desired result by changing profit.

Teodora and Nicolae[23] have selected 110 samples to demonstrate the point where professional accounting imitates with professional ethics standards. They have found that managers do not accept that accounting innovation and creativity is fraud. Their survey also tried to find out why companies are involved in creative accounting it is because companies are interested to attain more financial benefits by avoiding the legal complexities. They also found the answer of why some companies avoid innovation and creativity it is because managers have fear of stakeholders, internal and financial auditors.

Moldovan et al.[24] explained that what is the influence of company's provided information on the external users and particularly how this information reached outside the company. They have concluded that exact view of the company and creative accounting are inversely related. Gheraiand Balaciu[25] have used examples of those companies who were involved in famous fraud of the history like Enron, Xerox, WorldCom and Ahold Royal. Enron and WorldCom were bankrupt in 2002; they used accounting techniques to manipulate their account figures that lead to the lack of trust in audit reports and financial reporting. Amat et al.[26] identified the motives why company goes for creative accounting. First is income smoothing which minimizes the increase/decrease in profit, this method shows the increase in profit even when it actually decreases. Second is to maintain or increase its share price by showing an upward growth of company and the third reason is that it observes the limits that are comprised of forecast.

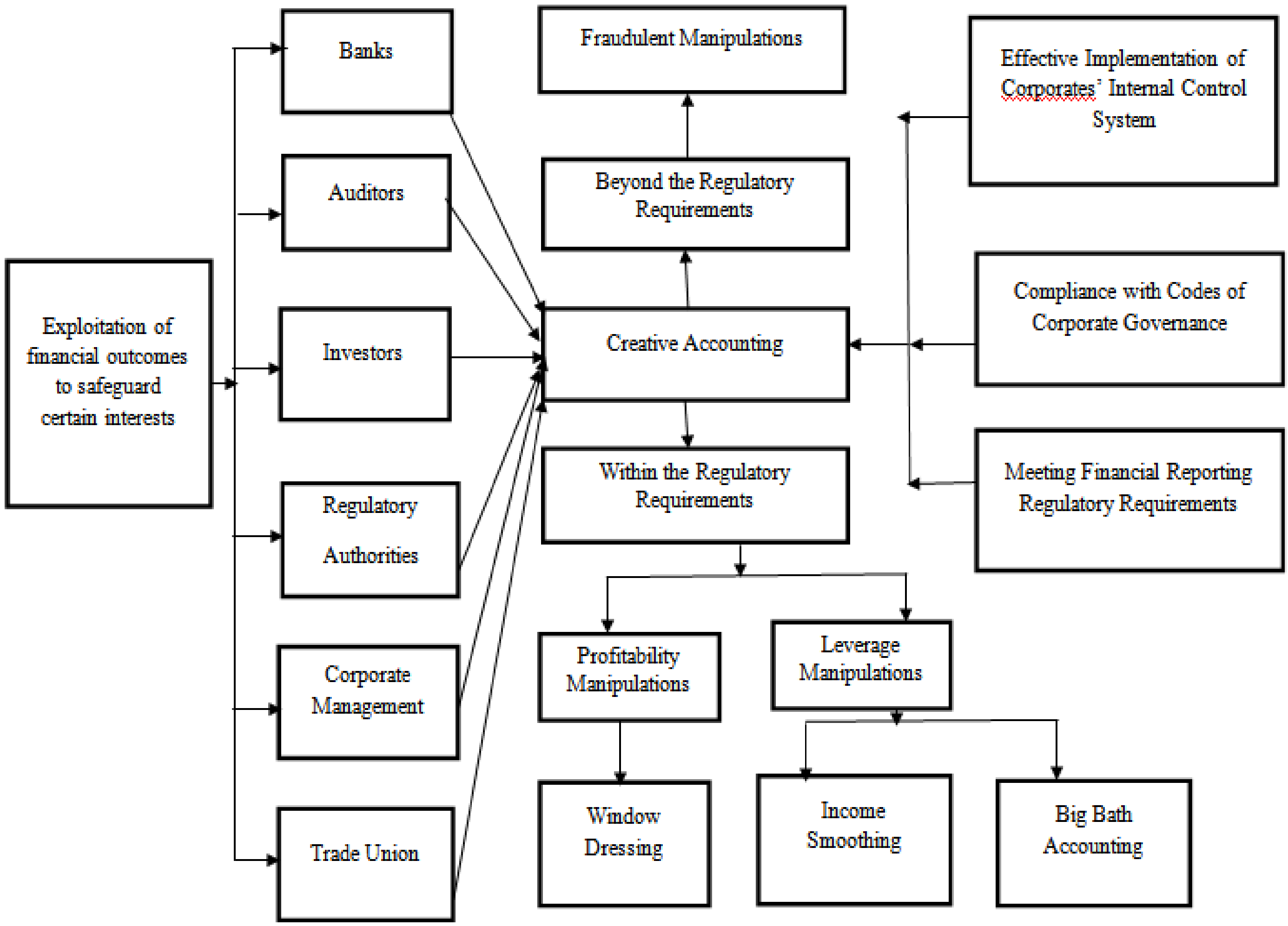
Managers are involved in manipulation of accounts in order to reduce taxes. Enterprises tend to gain the capital on the lowest possible price. In order to get this, Managers decreases the debt effects and also manipulate income and in order to increase Manager's wealth, managers are involved in the manipulation of accounting figures[27].

Shah and Butt[28] demonstrated that managers are involved in manipulation to attain the goals of profitability and value of share price. Managers want to satisfy shareholders and suppliers and to fulfill the analyst's forecasts and to make the taxes as low as possible managers manipulate the income. Ernst and Young[29] found that 85% of the fraudsters were workers and 55% were from the management at those companies which were bankrupt for example, Enron, World Com etc. The study also reveals that 85% of the managers who were involved in frauds spent few months in their companies. The issue regarding Manipulation of the accounts originated because of the following parties these are managers, auditors, analysts, shareholders, banks and other users[30].

Managers play an important role in creative accounting. It is the role of manager to take care of the shareholders wealth. They are involved in creative accounting to achieve the desired results. Investment analysts have a role to make sure that the share price that the manager has told is correct. For that, it is necessary for the analyst to have well knowledge related to creative accounting. These analysts should work without the pressure of a company. Regulators work to prevent the use of creative accounting. In order to demonstrate the correct picture, there is an element of flexibility in the regulations of accounting. Auditor's part is also important; it is the duty of auditor to give opinion about a particular company. Auditor should work independently regardless of being influenced by any factor. For Shareholders, in the short term creative accounting is good for them, as the share price increases. While in the long run, it is risky for them as company may end up bankrupt. Thus, they lose money. Commercial Banks they give advice to the clients making it more attractive to meet with their clients thus they agree on a term to refund credits. While employees and clients are include in other users. They believe that financial statements of a company present its true picture and it is not affected by any technique of creative accounting, that take care of managers interest instead of stakeholders.

Conclusion

The definitive purpose behind creative accounting is the exploitation of financial outcomes to safeguard certain interests. Banks, Auditors, Investors, Regulatory authorities, Corporate Management and Trade Union are the parties that are involved in creative accounting; they have certain motivations behind the involvement in creative accounting. These parties take advantage from the loophole in the Accounting Regulations.



Creative accounting can be done either "Beyond the Regulatory requirements" that consists of fraudulent manipulations, or can be done "Within the Regulatory requirements" that includes profitability and leverage manipulations. Profitability manipulations further includes window dressing and Leverage manipulations further includes Income smoothing and big bath accounting. Further, this study suggests that Manipulationscan be controlled by the effective implementation of Corporates' internal control systems, compliance with codes of corporate governance and meeting the financial reporting supervisory requirements.

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