Creative Accounting---Key Issues and Challenges

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Abstract

Creative Accounting is an accounting technique in which the loopholes of Generally Accepted Accounting Principles are used intentionally to enable the stakeholders to have a good image about an organization. An entrepreneur becoming the victim of fraud searches for answers to prevent such situation in future. A major implication of creative accounting is the deterioration of information quality in the financial statements which mislead stakeholders' decisions. The results suggest that creative accounting obstructs firms' technological progress and highlights the potential costs of managerial manipulation to alter reported earnings. A strong system of internal control helps deter employees from committing fraud. The aim of this paper is to review creative accounting and its implication for stakeholders and firms. The author finds strong evidence involved in creative accounting and extends his views by explaining its features with the help of convenient sampling method.

Keywords: Creative accounting, Manipulation, Ethics, Stakeholder, Accrual.

1.Introduction

Accounting facilitates identifying, measuring and communicating information according to Generally Accepted Accounting Principles or GAAP. The basic purpose is to provide sufficient economic information about business activities to different parties truly and fairly. Creative accounting or CA is an accounting technique where accounting practices deviate from standard practices to manipulate the accounting figures of an organization to serve specific purpose. CA helps alter revenue through aggressive accounting strategy. Further, it focuses on different aspects such as unreasonable revenue recognition, inaccurate accruals and estimates of liabilities, excessive provisions and sufficient reserves and purposeful infringement of reporting requirements. Instead of supplying true and fair information prepared on ethical basis to different stakeholders, in practice, however, every business community does not ensure accurate information about its economic activities. Rather, the community uses the knowledge of GAAP to distort true picture of financial statement of organization through CA. Both CA and accounting fraud involve manipulation of financial information through earning manipulation for achieving certain results(Marinakis,P.,2011). The term earning manipulation covers both earning manipulation and fraudulent accounting(Rosner,RL..2003). Major decisions like capital raising, debt covenants, executive remuneration, etc. are based on the information contained in annual reports. For conservative management, managers take opportunity to conceal deteriorating performance by choosing different accounting methods that increase income and conceal loss(Habib, A., Bhuiyan, B.U. Islam,A.2013)**.**CA applies the loopholes of GAAP and creates artificial accounting figures purposefully to enable the stakeholders to have a good image about the organization. This article explains the method of detecting CA and earning manipulation, and common motives behind their creation.

2.CA--Concept

CA is a new innovation in accounting through which an organization shows its economic activities in a manner different from traditional accounting practices. Business community here discloses earnings at certain levels by making misuse of the Accounting Standards to adjust accounting figures as far as practicable to arrive at predetermined objectives like creation of good image in the minds of stakeholders about the company, market expectations, maintenance of stable market position,etc. This practice has several implications to stakeholders and regulators. The flexibility of accounting process provides opportunity for manipulation, deception and misrepresentation. Corporate governance structures are most commonly associated with the earnings manipulations (Dechow et al.,1996). CA is a purposeful intervention in the external financial reporting process to obtain private gain as against the merely facilitating neutral operation (Schipper,1989). Managers alter financial reports to either mislead stakeholders about the underlying economic performance of the company or to influence contractual outcomes depending on reported accounting numbers(Healy and Wahlen,1999). CA practices in financial reporting have been termed as the art of faking or calculating or presenting the balance sheet, and the art of saving money (Tassadaq,F. & Malik,Q.A.,2015).Innovative aspect of CA in maneuvering accounting is an essential part in accounting practices (Jawad and Xia,2015).To get benefits from top management, managers are frequently tempted to show higher profits leading to adopting CA tactics (Vyas et al.,2015).

3.Literature review

Alzoubi (2016) in the analysis between company management and Earning Management or EM in Jordan shows that ownership structure has significant influence on EM since it greatly reduces the ability to manage earnings. Alhadab, M.,Clacher,I.and Keasey, K.(2013) while analyzing the relationship between real and accrual EM activities evidence that firms with higher levels of real and accrual CA have higher probability and lower survival rates in subsequent periods. Hadani, M., Goranova, M. and Khan, R.(2011) in their study indicates that shareholders' proposal has positive relation with subsequent EM. Okamoto,(2011) evidences that supporting principles-based accounting standards accompanied by true and fair override provisions. Klein,(2002) finds that audit committee independence is negatively related to EM. Xie B. Davidson, W. and DaDalt, P. (2003) show that board and audit committee members are associated with firms having smaller discretionary current accruals. Leuz, C. Nanda, D. and Wysocki, P.(2003) state that CA is more pervasive in countries where the legal protection of outside investors is weak as in these countries insiders enjoy more private control benefits. Geiger, M.(2006) provide evidence that national origin affects perceptions of CA in countries in the English-speaking world and Europe. Jeanjean and Stolowy,(2008) in their study find that pervasiveness of CA does not decline after the mandatory introduction of IFRS, rather, increases in France. Chen, A. Cheng, L., Cheng, K. and Chih, S.(2010) reveal that the reversal effect of pre-issue EM is a significant determinant of long-term performance of private issue. Results further show that post-issue stock performance and operating performance of firms using 'aggressive' EM significantly underperform those using more 'conservative' earnings management. Callao and Jarne,(2010) examine the impact of IFRS in the European Union on discretionary accounting practices in the periods preceding and immediately after the regulatory change and the results suggest that variations in accounting might be due to manipulation under international standards when compared with local standards. McNichols,(2000) shows that empirical procedures for aggregate accruals studies lag behind both theories of incentives to manage accruals and institutional knowledge of how accruals behave. The findings suggest that aggregate accruals models that do not consider long-term earnings growth are potentially misspecified resulting in misleading inferences about EM behavior. Rosner,(2003) in the analysis provides useful information to current and potential investors as well as to regulatory authorities observing the quality of firms' financial reporting more closely. Ratsula,(2010) suggests technique for managing the earnings by which management tends to report more loss to enhance the probability of future reported profit, especially during the situation of high organization stress or reorganization. Herrmann, Inoue and Thomas,(2003) in their investigation among Japanese managers' use of income from sale of assets find that earnings fluctuate through sale of fixed assets and marketable securities when operating income is below/above management's forecasting of income. Goel ,(2017) in his study on the impact of CA on stock prices shows that companies manipulate financial information mostly often in periods of uncertainty of the business in future. Bhasin, (2016) in his survey study in India shows that an initially determined accounting policy must be followed in all future similar circumstances that can minimize the use of estimates and achieve consistency. Lee, (2016) in a study conducted in South Korea concludes that write-off is an ideal item for manipulating accounting information to avoid reporting losses, maintain equal level of earnings over the years, and to meet the analysts' forecasts. Shahid and Ali, (2016) in their research show that CA has significant impact on fair and objective financial reporting in Pakistan and suggest to put emphasis on corporate governance and strengthening of ethical values. Patnaik et al., (2014) in their survey in selected private sector undertakings conclude that window dressing practices are prevalent in majority of corporations and external auditors encourage such practices for their own interest. Renu and Aggarwal, (2014) highlight CA in negative sense with the help of CA methods adopted by Enron Company and Satyam Computers leading to their collapse. Yadav, (2014) finds that CA practices boost profit under unsuitable situation and suggests to minimize it by good corporate governance practices. Bhasin ,(2013, 2015) examines India's Enron, Satyam Computers CA scandal and suggests increasing rate of white-collar crimes demand stiff penalties, exemplary punishments and effective enforcement of law. Rajput, (2014) finds that CA exists due to lack of awareness and information level of investors. He highlights the role of government and various agencies like SFIO and India Forensic for proper handling of the problem. Blessing, (2015) in the study evaluates the use of forensic accounting techniques to curb CA. Momani and Obeidat, (2013) investigate the effect of ethics on auditors' ability to detect the practices of CA in Jordan. Osazevbaru, (2012) investigates the effect of CA on firm value in Nigeria, and reveals that CA positively affects firm's value. Idris et al. (2012) investigate the practice of CA on firm value in Nigeria and suggest for enforcing preventive and punitive measures on those who are engaged in the practice. Sansusi and Izedonmi (2014) in their investigation on CA practices in Nigerian commercial banks recommend CA as a serious crime and as such accounting bodies, law courts and other regulatory authorities need to adopt strict measures to stop the practice. Tassadaq and Malik (2015) in their empirical study in the industrial sector of Pakistan observe that a company is involved in frauds or scandals due to several factors like unethical behaviors, agency problem and non-professional attitude. Lau and Ooi (2016) in their study on fraudulent financial reporting in Malaysia. show that the most commonly used method of CA is the overestimation of revenues through recognition of fictitious revenues from product sales to bogus customers. It turns out that unethical decisions of managers have led to significant adverse consequences on decision-makers and society as a whole.

4.Objective of the study

The prime objectives of the study are: i) to find out the reasons responsible for CA; ii) to examine the possible ways of CA; iii) to discover whether CA is ethical in practice or not and iv).to offer suggestions to overcome the unethical practice.

5.Data and Methodology

The study is dependent on both primary data and secondary data. Size of chartered accountants and auditors being large, the study adopts a convenient sampling method. The research comprises of 122 participants working in different companies including chartered accountants, auditors and accountants. In this paper, CA covers EM and earning manipulation. The researcher, being an external analyst, has to depend mainly on literature available on this particular issue in the form of books, journals, research articles, websites, etc. Primary data has been collected through issue of questionnaires, structured interviews, etc. Although, there was found apathy or indifference on the part of executives in supplying information, the researcher could overcome the same through moral persuasion and intensive pestering. It was made clear to them that the information so collected will be exclusively used for academic purpose and proper secrecy will be maintained. Respondents selected in the sample are chosen purposely either to serve a particular object or because it is felt they possess all the characteristics of the parent population. The study being conceptual and descriptive expresses the author's own opinion and opinion of some reputed authors.

6.Discussion

6.1.*Significance of CA*

Accounting provides true and fair economic information to interested groups to satisfy their needs and, thus, helps the management take rational decision. But in practice, every business community does not ensure accurate information about its' economic activities. Rather, the community misuses knowledge of GAAP and creates accounting information to mislead the stakeholders. Presented results do not reflect authentic picture of the business but are tailored to the desired goals. Operating results published by the organizations are based on tactfully adapted and altered data. CA has become popular as GAAP are flexible and leave much scope for subjectivity in evaluation resulting in manipulations, frauds and biases. An entity can influence its material and financial position with false transactions thereby distorting the real picture.

6.2.Reasons responsible for CA

CA is a systematic misrepresentation of economic aspect of an organization and is a strong tool for accounting scandals. GAAP have enough scope for adopting different accounting policies for specific accounting issues and hence an organization uses its knowledge of the principles and manipulates the figures, misleads the stakeholders about its real financial standing and makes artificial increase or decrease in revenue and inaccurate accruals and estimates of liabilities, excessive provisions, etc. to carry out sophisticated frauds. It exhibits growth of profit or loss rather than volatile one and increases or decreases equity price through manipulating earnings by applying GAAP and declaring high or low rate of dividend to attract investors on the basis of stock performance.

6.3.Ways of CA

CA is a technique in which the business organization applies its knowledge of accounting rules to manipulate the figures to build up good image in the eyes of the people. There are several ways of CA viz. reporting the restructuring charges of future years in current year and increasing the earnings of an organization. Expected life of fixed asset reduces depreciation charge if the outdated or damaged items are included in the inventory at current value. Perols, et al. (2011) find out that an organization manipulates earning by inflating revenue to report significant growth. Chen et al. (2005) find out that unusual movement in gross margin manipulates earning. Summers et al. (1998) explore that inventories and account receivables were involved in earning manipulation by 31% to 61%. Othma, et al. (2006) observes that inadequate provision for doubtful debts have an impact on future earnings. Bartov, E. (2009) explores that companies do earning manipulation through changing the level of accruals. Duh, et al. (2009) find out that reversal of previously recognized impairment losses create reason for EM. Teoh, et al.,(1998) find out that bad debts and depreciation estimations help manipulate to increase the income. The most widely used creative accounting techniques are: i)manipulation of balance sheet items; ii)changes in accounting policy; iii) changes in the value of money; iv)overestimation of revenues; v)manipulation of receivables write-off; vi)manipulation of accruals.

6.4.Common motives behind accounting fraud

Accounting fraud involves employee fraud, payroll fraud bribery, kickbacks and insider trading, intentional falsification of financial reporting, etc. GAAP and IFRS permit companies to realize certain items at the discretion of the management viz. recognition of revenue and handling extraordinary income and expenses. The most common type of fraud is made through premature and factious recognition of revenue (Eining,1997). Accounting fraud involves factious transactions and higher litigation against auditors(Bonner,1998).EM and accounting fraud involve common component manipulating financial information for achieving certain results (Marinakis,2011).Common practices are i)wrong classification of accounting practices: Accounting practices are wrongly classified with fraud intention and violate GAAP. ii)misstated subjectivity of measurement: A research on property casualty's insurance claim loss reserve shows how CA takes place among insurers(Beaver,2003). Organizations increase the level of earning by using discretionary accrual(Shen,2005). A firm uses EM to avoid reporting negative earnings and also to maintain market expectations(Gore,2007). Management manipulates real activities for reducing annual reporting losses (Roychowdhury,2006)). Basic motives behind CA are: i)obtaining personal gain; ii)competition; iii) attracting investors; iv)increasing/maintaining level of capital; v)buying time for not settling debts; vi)beating analysts' forecasts about company performance. CA techniques are mostly undertaken by managers with unscrupulous intention to mislead the various segments of society. Thus, the mangers are responsible for the misuse and abuse of CA, since in order to fulfill their objectives, they defy the ethical consideration of CA practices. Often, they resort to totally unethical practices which are out of the limits of accounting standards posing threat to the very existence of the company (Nag, 2015).

6.5.Main types of real activity manipulation

- Sales manipulation-Accelerating sales through price reductions or disagreed on credit sales award increase the results of a year resulting in lower cash flow in the following periods (Roychowdhury,2006)).
- Overproduction- Managers prefer to use overproduction with the intention to reduce costs through the achievement of economies of scale (Roychowdhury,2006).
- Discretionary cost reduction-Reduction in research and development expenditure alters the results of an organization that could also have negative effects on companies' strategy causing decrease in future results (Cohen et al., 2008).

6.6.Methods for preventing CA

- ✓ Internal control helps prevent fraudulent activity. One commits fraud under situational or financial pressure when the opportunity to commit fraud is present and the perpetrator easily rationalizes the fraudulent activity.
- ✓ Separation of accounting functions can reduce opportunity to commit fraud. Segregation separates record keeping, authorization and review functions in the accounting process. For occurring fraud, two employees must collude to perpetrate the crime.
- ✓ A strong control environment with a written set of concise policy demonstrates ethical behavior. One of the easiest ways to establish a strong moral tone is to hire morally sound employees.
- ✓ Management usually feels pressure to meet organizational goals or receive incentives to meet certain goals. An independent party can examine financial statement at certain interval to prevent management from doing in overly aggressive adjustments to the financial statements. An auditor can review financial statement or deter employees from knowingly presenting incorrect financial statements.

Efficient techniques include i)adaptation of accounting standards for consistency in the application of accounting methods; ii)hiring independent directors and members of the audit committee; iii)sound corporate governance; iv)developing whistle-blower policy; v)awakening code of ethics; vi)development of forensic accounting; vii) investors' awareness of the practice of manipulating financial information;viii)consistent enforcement of penalties by national authorities

6.7.Auditor's role in detecting accounting fraud

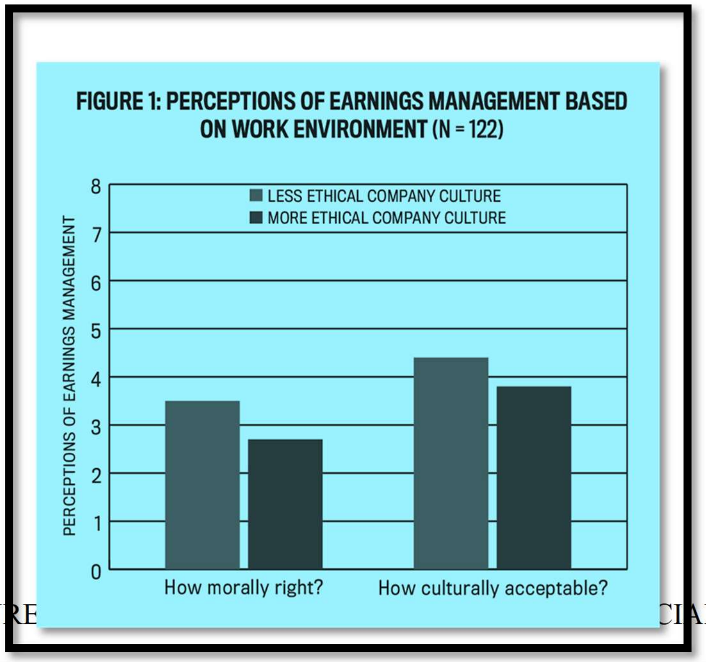
An auditor is watched dog, not bloodhound. Auditor should not make perception in advance about the misconception with the management. Fraudulent financial reporting involves intentional misstatement in financial statement to deceive its' users**.** An auditor has professional and legal responsibility to confront the charges with management in acceptable or unacceptable accounting practice beyond the line. Audit firms perform greater reporting conservatism than auditors employed by other accounting firms(Hodge, FD.,2013). Audit firms' auditors have greater skills and professional skepticism than other audit firms which really put greater constraint on EM(Karamanou, I. et al., 2005).

6.8.CA and ETHICS

The term "ethics" refers to moral character implying conformity with ideal code of conduct. Ethics include set of rules and standards guiding individuals and business communities. Rule, on the other hand, refers to an end to be achieved. Professional ethics refer to code of conduct applied to professional persons. Uşurelu, Marin, Danaila, & Loghin (2010) stated that ethics should be followed by an accountant and CA is big challenge for them. Ethical actions of profession are collections of individual action like ethical conduct of an organization. Professional bodies have specific responsibilities and duties not only to their clients but also to society as a whole. However, at present there are series of scams and corrupt practices in every sphere of business activities. The Companies Act directs an organization to conduct its affairs in the interest of stakeholders in a credible, fair and lawful manner. Professionals should, therefore, function in favor of stakeholders ensuring accurate state of affairs. However, CA usually seems to be considered as ethically obscure and hence, it does not facilitate protection of the interest of stakeholders.

6.9. How ethical is EM?

Company culture including the tone at the top can influence managers' perceptions of EM. A survey among 122 participants working in company indicates that they have worked in an environment where fraud has occurred. Managers having worked in a less ethical company culture perceive EM more morally right and culturally acceptable than managers having worked in no such environment(FIGURE1and FIGURE2).The findings suggest that at the top and corporate culture influence how individual managers perceive the appropriateness of engaging in aggressive accounting practices.



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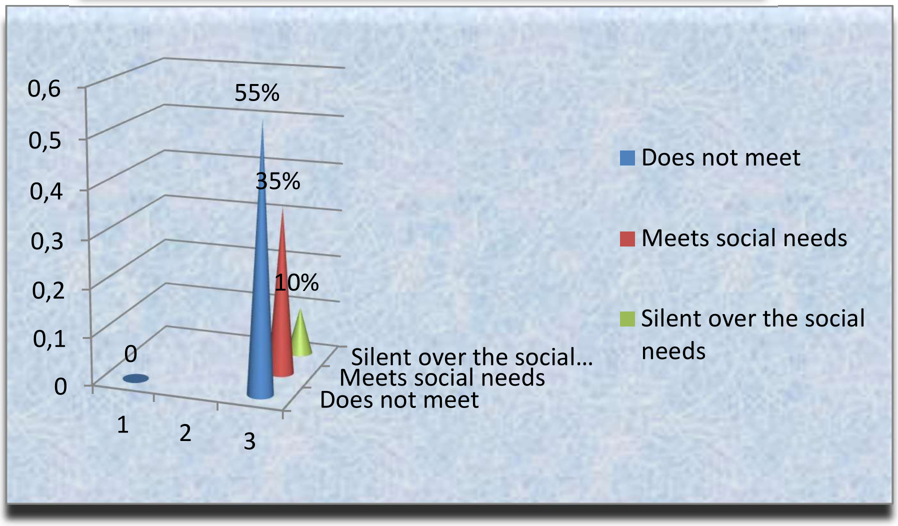

7.Results

- Through CA, business communities create their own accounting data for the purpose of maintaining market expectations and stable market position by applying the loopholes of GAAP.

- CA in an organization misleads the stakeholders about its' financial position; artificial increases or decreases in its earnings, estimation of excess provisions, etc. affect the equity price to attract investors.
- CA helps an organization boosting share price by reducing seeming level of borrowings. It is less risky and creates an appearance of sound profit trend. Such an atmosphere facilitates to raise necessary fund through fresh issue of shares.
- About 55 per cent respondents are not in favor of CA as it manipulates accounts and does not meet social needs properly; 10 per cent of the respondents have nothing to say about the utility of CA. The remaining 35 per cent respondents argue that CA is of vital importance as it creates good image of the organization's activities to stakeholders by fabulous accounting information.

8.Recommendation

Dynamic and complicated nature of business transactions along with the involvement of managers, few auditors, slow work of regulatory bodies, etc. are key obstacles to reduce the impact of CA. A lot need is to be done to check all malpractices in the accounting principles and techniques and encourage judicious use of CA. GAAP usage should be subjected to basic SAS and IAS standards. The public accounting profession can take proactively approach need. Training schemes need to be given to auditors with annual update on how they are perpetrated. Steps need to be taken knowing that there is manipulation of earnings within GAAP and income smoothing such as inappropriate revenue recognition, accounting policy change, adoption of new standards or methods, write-off, asset sales, provisions, discretionary accruals, direct charges to retained earnings, all the other accounting and fraudulent reporting, etc. In addition, more efforts should be made for introducing tools necessary to identify CA techniques to better equip Chartered Public Accountant. Education through business and professional publications can help public by publishing articles on how to detect and deter CA schemes. Since auditors are in the best capacity to judge corporate earnings quality, auditors should prepare a quality report on the income statement. Further suggestions for minimizing unethical practices of CA are: i)reducing alternative accounting choices by regulatory bodies; ii) ensuring proper accounting regulations; iii) sound professional code and corporate governance; iv) honest and ethical behavior of authorities; v) reducing scope of estimates and proper accounting legislation; vi) developing training programs; vii) developing accounting curriculum in higher institution of learning; viii) staffing audit unit with forensic experts; ix) periodical rotation of auditors; xii) insisting efficient whistle blower policy to report any financial irregularity; etc. It is unrealistic to assume that CA practices can be completely eliminated; but best possible efforts can be made to minimize at least the negative effects of CA practices by adopting the accounting standards, giving more importance to ethical considerations, decreasing the flexibility of the managers in choosing different accounting methods, and introducing forensic accounting for detection and prevention of white-collar frauds. Moreover, strong punitive measure should be taken against all those who are found culpable in the act of CA practices. We are optimist that corporate sector may be motivated to provide "true and fair view" of the financial statement if some of these recommendations are sincerely implemented.

9.Conclusion

The concept of the CA is difficult to define and very subjective to decide whether it is an appropriate accounting treatment or it is an EM. The foregoing discussion leads to infer that business community should disclose true and fair financial picture and protect the interest of different parties. But as the traditional way of presenting the day-to-day activities of an organization might not show the real situation, CA does not fully protect the interest of the benefitted parties of organizations. A strong sense of ethics discourages CA. Managers have some degree of flexibility and discretion in reporting their financial statement to reflect underlying economy of their organizations. This flexibility provides management opportunity to manipulate earnings. There is a relationship between professional ethics and CA. Managers may choose accounting treatment guided under GAAP to reduce its risk of violation even though it is not the most appropriate method to reflect the corporate economic situation. From the whole flow of CA, it is required to examine the pattern and motivation of CA- what really drives the good and bad side of CA. Management compensation is one of the most important incentives for CA. CA should be discouraged even if investors could see good image through accounting numbers.

10.Research comment

Fraud detection in the financial statement is front end burner. Users of financial statement must be aware of type of accounts manipulated. They must be able to judge the circumstances in which management is mostly involved in CA.

Accounting Standard bodies like IASB or GAAP should have the responsibility to reduce the role of discretionary accruals by developing and revising the accounting standard. Although most of the Accounting Standards are being revised, there is still more room available in it for discretionary accrual which should be minimized or eliminated by implementing the suggestions. Use of CA certainly cannot be completely removed, but it can be minimized using various solutions. Carefully articulated and professionally executed control schemes can stop the irregular financial practices fostering unexpected strains in the economy globally. Accounting professions should accept more responsibilities to check this cancerous situation. Everybody is affected, one way or the other by this dilemma. It is high time the high-spirited accountants seek for a financial messiah.

11.Research scope

Future contribution related to regulatory issues is worthwhile for research to address EM around the possible adoption. Most academic studies do not attempt to provide whether CA is widespread or infrequent. Findings on research allocation effects on CA suggest the need for future empirical and theoretical research on this issue. However, future research will focus new insights if it broadens the issues having addressed. Better conflicting finding on the effects of CA on stock prices and resource allocation is badly needed in the economy. Similar study may be conducted to explore areas in terms of factors affecting CA practices and divergent research methodology to strengthen the results of the study.

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