

# [Concepts in creative accounting](https://assignbuster.com/concepts-in-creative-accounting/)

Creative Accounting is usually depicted as a smeared subject and hence considered as an adverse deed. It is quite common that as and when the words “ Creative Accounting” are indicated, the thinking that surfaces in one’s head is that of manipulation, dishonesty and fraud. It is apparent that if at all any error appears when resorting to Creative Accounting; it is not because that the tool is faulty, but the user is to be blamed. Progressively more companies have avoided disasters by adopting Creative Accounting and there are also numerous instances of companies which could wriggle out of adversities by using it. If creative accounting adheres to ethical and legal standards as well as the generally acceptedInternational Journal of accounting principles (GAAP), they can produce enormousprofits to the business and its shareholders or help strive through tough and challenging periods. Furthermore, attempting to completely illegalise it is impractical and narrows the growth of the accounting profession with such restrictions. Alternatively, educating accountants on ethical behavior and promoting professionalism could be a better solution.

In 2008, Hooper, Davey, Liyanarachchi, & Prescott has defined Creative accounting as a method whereby accountants use their understanding of accounting rules to manipulate the figures stated in the financial statement of a business. Basically it deals with various matters of conclusions and perseverance of conflicts between perplexing approaches to the presentation of the consequences of financial dealings and transactions.

In 2008, Hooper et al. opined that on a wider perspective creative accounting can be considered as worthy provided an accountant puts this tool in use with a judgement based on sturdy moral and ethical footing to objectively portray the performance of a company. Nevertheless, creative accounting can also be construed as an evil accounting exercise, as there are negative zones that permit literally ‘ creative accounting’. A pertinent instance for this is the common practice of submitting a well looking report to the shareholders without violating the boundaries of the letter of the law (Hooper et al., 2008). The lack of rigidity within the criteria and law compromises probabilities for manipulation and distortion; activities that may be considered unethical by most of humanity.

In 1995, Breton and Taffler stated that it is a hard task for individual shareholders to distinguish the facts and the results of accounting manipulation because of lack of personal expertise, unresponsiveness or a reluctance to undertake a meticulous scrutiny. This botch on the stakeholders’ part is not a serious issue as far as the market proficiency is concerned. While concluding their research, Breton and Taffler opined that though there is certainly a scarcity of creative accounting strategies in the perspective analysts, the number of accounting professionals required is relatively low “ for the market as a whole appropriately to process window dressed numbers”. However, in 1999, Healy and Wahlen backed with reports stated that creative accounting prior to equity issues does have an impact on share prices, vividly establishing that the potential investors do not necessarily take interest in creative accounting.

The major areas where creative accounting can make vital contributions are: governing elasticity, lack of rules, an opportunity for managerial judgment in respect of expectations about the future, the scheduling of some dealings, the use of simulated businesses and lastly the reclassification and presentation of financial results.

Accounting regulations normally allows policy options; valuation of asset is a good instance for it. International Accounting Standards offer a selection between carrying non – current assets at either depreciated historical or cost revalued amounts. It is up to the Business entities to change their accounting policies depending on the situation on ground. Schipper stated in 1989 that any change in policy is comparatively noticeable in the year in which it is adapted; but in the following years such changes may not be easily distinguishable.

There are several areas which are not amply covered by proper regulations. One good example for this is relating to accounting regulations for various stock options. No clear cut mandatory guidelines are set as yet in this area. Even in some of the developed countries such as Spain; accounting regulations in some areas are extremely scant. The crediting process and the size of the pension liabilities and certain norms for accounting financial instruments can be stated as some of the examples.

There is opportunity for managerial judgement for appraisal in discretionary areas. In 1988, Mc Nichols and Wilson took bad debts provision as an example and examined the discretionary and non-discretionary elements in it.

In order to render a good look to the accounts, the Management can decide upon the timing of even genuine transactions. For instance, if a company has made an investment at historic cost which can be vended for a higher price, being the current value. It is the prerogative of the managers of the business to opt as to which year they sell off the investment so as to show an increased profit in the financial statements.

Artificial business transactions may be incorporated to manipulate balance sheet amounts and to hobble profits between different accounting periods. This can be accomplished with the tacit connivance of a third party; such as banks, which is willing to enter into two or more correlated deals. A vivid example for this can be found in an agreement for selling an asset to a bank and then lease the said asset for the rest of its life span. The sale value under such a ‘ sale and leaseback’ agreement can be inclined above or below the present value of the asset as the variance can be remunerated for by reduced or increased rentals.

These are poorly researched in the literature. In 2001, Gramlich et al. suggested that companies may manipulate balance sheets to reclassify liabilities so as to report a more rosy liquidity and leverage ratios. The presentation of financial numbers provides a distinct style of creative accounting that is based on cognitive reference points. In the year 2000, Niskanen and Keloharju described that “ the idea behind this behaviour is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million”. There were many other studies such as one undertaken by van Caneghem in 2002 have clearly showed that some trivial fiddling of figures does happen in order to achieve some noteworthy landmarks.

In 2002 Naser and Pendlebury questioned senior business auditors about their involvement of creative accounting. According to them a substantial proportion of all types of companies use creative accounting procedures to certain magnitude. Several research studies scrutinized a specific aspect or practice of creative accounting. The entire studies confirmed that creative accounting using a precise technique. In 1976 Barnea et al. explained classificatory smoothing with the deployment of extraordinary items and their results, founded on a study of 62 US companies, indicate that classificatory smoothing does happen.

A large number of accounting appraisals and estimates are allowed by IFRSs. Thefeature of accounting estimates is that the amount considered for a preciseelement reflected on the financial statements is not an exact figure. Mulford and Comiskey (2002: 64, 26) is of the view that the areas of flexibility within the IFRSs could indicate the areas of creative accounting. According to Baralexis (2004: 440) since the IFRSs is an essential condition for creative accounting, there are two types of creative accounting – the legitimate and the illegitimate. It is very hard to differentiatebetween creative accounting and the realistic application of business judgement.

When all the aspects discussed above is taken into consideration, the very question automatically raised would be as to why flexibility is allowedwithin the IFRSs in the first place if the menace of manipulation of financialinformation is apparent. Healy and Wahlen (1999: 366) opined that the financial statements are the best evidence for the knowledge of a manager about his company. They further stated that accounting standards should allow managers to make judgements and thereby conveying the necessary data to the users of financial reports which could possiblyenhance the worth of accounting. Mr. Arthur Levit, the former chairman of Securities and Exchange Commission (SEC) defends the practice of flexibility in accounting standards with the following observation:“ Flexibility in accounting allows it to keep pace with business innovations.” (Levitt 1998: 16). McBarnet and Whelan (1999: 39) noted that in the UK, where the use of IFRSs is extensively prevalent toprepare financial statements, the emphasis is on principles rather than on rules. They maintain that doctrines are considered as the only means to seize the intricacy ofaccounting.

THE EFFECT OF ESTIMATES IN FINANCIAL STATEMENTS BY ELIZABETH JOHANNA RAUBENHEIMER

Creative accounting is of great assistance to sustain or increase theshare value by maintaining debt level to lower risk and bypresenting enhanced profits in the financial statements. Due to the high share price, the company will be able to amass new capital easily and will be of immense help during takeover efforts. There are some authors who is of the view that delaying tactics resorted by management in publishing the financial figures to the market with an ulterior motive to extract some benefits from the delay can be described as creative accounting. However, if the management’s objective is not to hurt the interest of the investors, such actions cannot be termed as fraudulent.

Use or Abuse of Creative Accounting Techniques Normally, businesses choose to portray a stable trend of growth in profit instead of displaying explosive profits with a chain of intense increases and drops. It can be achieved by setting unreasonably high provisions for liabilities against assets in bright years to enable a reduction in these provisions thereby improving the profits in bad years. The supporters of this tactic is of the view that it is a measure against the ‘ short-termism’ of adjudging an asset on the basis of the profits earned in the immediate ensuing years. This approach also shuns high anticipations during bright periods so that the management is not embarrassed when the performance is not that good as expected in the following years. It is contended against this backdrop that if the business environment of a firm is indeed explosive or impulsive; then the stakeholders have every right to be aware of this fact so that income smoothing may obscure enduring fluctuations in the profit movement.

In 1991, Revsine contemplated the issue and opined that both managers and investors are benefited from ‘ loose’ accounting standards that allow managers with autonomy in scheduling the reporting of income. He went on to add that accounting as a system has the principal duty to constantly checking the agreements between managers and other agencies such as financial institutions, monitor the market mechanisms to ensure that they are operating effectively, be alert so that the accounting manipulation potentials can be detected in time and reflected accordingly in the pricing and contract decisions. The works on the morals of prejudice in accounting policy choice is appraised at the ‘ macro’ level of the accounting watchdog. Correspondingly, these literatures can be applied to the prejudice in accounting policy options at the micro level of the administration of businesses that is inherent in creative accounting.

It is very interesting to analyse the two contrasting stands propounded by Ruland and Revsine. A close scrutiny of the opinion of Ruland reveals that he makes an obvious differentiation between the deontological and teleological views. According to him, deontological views are moral rules which apply to actual actions and the teleological views are that any action should be adjudged on the basis of the moral substance of the results. Revsine appears to be more lenient towards teleological perspective of accounting in the private sector so that the managers have the liberty to opt the alternatives provided in ‘ loose’ standards to attain their preferred goal. However, when he talks about deontological view of accounting in the public sector; he advocates more stringent criterions to avert such manipulation. Obviously, we tend to question whether the existence or non-existence of market restraints and controls excuses such moral contradiction. Ruland further explained the difference between a ‘ positive’ obligation to present an unbiased accounts and a ‘ negative’ responsibility where managers are duty bound to explain the states of affairs they fail to avert. We can conclude that Ruland accords precedence to the ‘ positives’ whereas in Revsine’s scheme of things, all results are reckoned to be linked with the manner of contracting and price-setting and the difference is not recognized. The ‘ duty to refrain’ would involve eluding the prejudices intrinsic in creative accounting while the ‘ duty to act’ would encompass following the magnitudes to be accomplished by creative accounting.

In 1995, Leung and Cooper conducted a survey of 1500 accountants in Australia and established three ethical problems faced most frequently were conflict of interest, clients’ insistence to manipulate accounts and clients’ eagerness to evade tax. However, two surveys undertaken in USA on attitudes to creative accounting; both highlighted a variance in accountants’ attitudes to creative accounting contingent on whether it results from misuse of accounting regulations or from the manipulation of business dealings. Further researches by Fischer and Rosenzweig in 1995 discovered that MBA and accounting students were more cynical than accounting professionals of manipulated transactions. On the other hand, accounting practitioners were severely criticizing the abuse of accounting rules than the students. Similarly, Merchant and Rockness in 1994 through their extensive studies established that accountants were relentlessly criticizing when presented with various scenarios of creative accounting. They also pointed out that the accountants lashed out at abuse of accounting rules and they were less critical about manipulation of transactions.

An attempt was made by Fischer and Rosenzweig to propose two probable reasons for accountants’ attitudes. First and foremost, accountants may resort to a rule-based approach to ethics instead of its impact on the users of the accounts. Secondly, accountants consider manipulation of accounting rules is their prerogative and within their purview and as such call for an ethical judgement, while the manipulation of business transactions falling under the domain of management and hence the same ethical scanner is not applied. Merchant and Rockness also stated that a variance in accountants’ attitudes towards creative accounting is greatly influenced by the impetus of management. It has been noticed that creative accounting founded on blatant self-centered motives invite greater censure than the impetus for promoting the interest of the company. Anyone, be it an accountant or a manager, who dares to adopt a position against creative accounting would certainly face a lot of pressure as any other whistleblower or dissenter. There were some extreme instances where loss of reputation was the result for failing to act.

Apparently, accounting professionals and managers are required to exercise a fair amount of discretion and judgment on a regular basis and as such it is imperative for them to have a thorough knowledge of ethical sensitivity relating to various creative accounting practices. There could be extensive pressure put on managers and accountants to involve themselves in creative accounting. In order to satisfy the shareholders and to impress the stock market, companies might compel accountants and managers to twist the quarterly financial reports to appear them attractive. Even the accountants and managers may have concern that the management might evaluate their performance without according much weightage to the precision of the financial statements prepared by them; but as to how far the statements are in favour of the management. Therefore, the practicing accountants are required to possess adequate knowledge, good discretion and judgement, sound moral values and courage to face and withstand the pressure from the management side. Hence, if the curriculum for accountants and managers can instill ethical sensitivity to creative accounting, it could perhaps assist in reducing their penchant to involve in these malpractices.

Attitudes of Students and Accounting Practitioners Concerning the Ethical Acceptability of Earnings Management

To conclude, the evidence suggests that creative accounting is a very effective tool. However, if it is not used wisely or falls in the possession of the wrong people, it will have negative impact rather than contributing value addition. If creative accounting adheres to ethical and legal standards as well as the generally acceptedInternational Journal of accounting principles (GAAP), they can produce enormousprofits to the business and its shareholders or help strive through tough and challenging periods. Furthermore, attempting to completely illegalise it is impractical and narrows the growth of the accounting profession with such restrictions. On the other hand, if accountants are educated on the importance of ethical behavior and professionalism is promoted, this could help solve the problem.