

Creative accounting and ethics flashcard



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The accounting process consists of dealing with many matters which includes judgment and resolving conflicts between challenging approaches to the presentation of the results of financial transactions. This flexibility provides opportunities for manipulation, deceit and misrepresentation and is widely known as creative accounting (Harris n. d.). Creative accounting can be defined as a process which involves the accountants to exercise their knowledge of accounting rules to manipulate the figures reported in the accounts of a business.

Other terms used may include income smoothing, earnings management, earning smoothing, financial engineering and cosmetic accounting (Boskin 2005). The ways that companies usually manipulate their accounts include recording revenues too soon, recording bogus revenues, boosting income with one time gains, shifting expenses and income forward and backward, failure to disclose liabilities and changing estimates such as bad debts, litigation costs, capital asset lives, and pension assumptions (Schilit, cited in Davin n. .). While opinions on the acceptability of accounting manipulation vary, it is often perceived as reprehensible (Gowthorpe & Amat 2004).

Hence, knowing when to do the right thing is both a question of ethics and professional responsibility. Motivations for Creative Accounting An important factor in accounting regulation is the sheer scale of the economic impact of accounting rules. The choice of an accounting rule may have a very significant impact on, for example, reported profits.

The level of profitability of a commercial entity potentially affects distributions to owners, wage and salary negotiations, levels of pensions funding, ability to borrow or to raise further risk capital, taxes paid and so

on. Regulators may attempt to take the economic consequences of their actions into account, but they are likely to be confounded in many ways. The problem is that when the stakes are high, there are considerable incentives for financial statement preparers to confound the work of the regulators (Gowthorpe & Amat 2004).

Management's participation in earnings management may call into question the integrity of management. Many stakeholders and shareholders in the organization carefully scrutinize the ethics behind management's actions. The principal-agent relationship is fiduciary, which is a relationship based on trust. The managers (agent) have the authority to act on behalf of and instead of the owners (principal), using a degree of their own discretion. Any perceived violation of this trust can breed skepticism and mistrust (Belski & Brozovsky 2002).

Tax is indeed the most significant element in almost all companies. In countries with strict conservative accounting systems the process of enhancing the income can be particularly pronounced because of the high level of accumulated provisions. Not only that, another reason for manipulating the accounting data can be linked to the cost of external borrowing. Banks only grant loans to enterprises after the entities establish their credit rating first and secure the risk level on the basis of the borrower's credit standing.

Thus, the price of loan relies on the risk assessed. The higher level of risk an entity has, the higher the interest rate will be charged. Arguments for Creative Accounting Sometimes, the accounting rules allow a company to

choose between different accounting methods. Management wishing to show earnings at certain level or following a certain pattern seek loopholes in financial reporting standards that allow them to adjust the numbers as far as is practicable to achieve their desired aim or to satisfy projections by financial analysts.

Genuine transactions can also be timed so as to give the desired impression in the accounts. In this sense, income smoothing does not violate the accounting regulations, but enhances potential shareholders' perceptions of the entity. Generally, companies prefer to report a steady trend of growth in profit rather than to showing a series of dramatic rises and falls. This is done by creating high provisions for liabilities and against asset values in the good years in order to reduce these provisions, thereby improve reported profits in bad the years.

Shareholders also benefit as it decreases the apparent volatility of earnings and so increase the value of their shares. Managers smooth income to disseminate inside information regarding the firm to investors more effectively via earnings management in order to eliminate some of the information asymmetry between managers and shareholders. In this sense, earnings management appears to benefit both managers and shareholders. A variant on income smoothing is to manipulate profit to tie in to forecasts. For example, the accounting policies at Microsoft are designed, within the normal accounting rules, to match reported earnings to profit forecasts. An assumption from the informational perspective is that the accounting disclosures contain information which possesses a certain extent of value to its stakeholders in providing useful signals. This perfectly respectable and

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highly conservative accounting policy means that future earnings are easy to predict. Besides, company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news.

Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. By boosting the company's profit figure, it will distract attention from negative news of the company and prevent the fall in share price. Another ground for manipulating with accounting data can be attributed to the cost of external borrowing. Banks granting loans to enterprises normally establish their credit rating first and fix the risk level on the basis of the borrower's credit standing. The price of loan depends on the risk assessed.

The more risky an entity is, the higher the interest rate will be (Boskin 2005).
Arguments against Creative Accounting There are ways that smooth earnings can be attained without violating GAAP, thus creative accounting is not technically wrong. Real smoothing is altering the timing and occurrence of actual events to achieve the desired objective. However this is limited when compared to how much you can change when you use false transactions. Many upper level managers' compensation plans revolve around bonuses based on increase in stock price.

This incentive just adds to a manager's desire to inflate the stock price, for his or her own personal gain (Davin n. d.). When earnings are unusually high, managers attempt to reduce earnings because their bonus plans have already generated maximum bonus and managers desire to shift some

income to future years when additional bonus could be earned. Further, corporate headquarters is also responsible for dividend smoothing. It is essentially the same thing as earnings management in that dividends are managed to send a message to shareholders.

For example, a company that cannot afford to pay dividends will borrow funds to pay them in order to appear that they are operating profitably in an attempt to control stock price. Manipulation is done to fool the investors into believing that their stock is less risky than others while they may be starting a snowball rolling down a mountain effect. This is true with meeting analysts' expectations. If sales drop and managers are expecting a certain level of sales, then they smooth a little. The next period sales stay the same and their expectations increase, they smooth more.

Now, the manager's options are to report what is really happening or to keep fudging until he finally ends up getting caught. The problem worsens during economic downturns and there is more abusive financial reporting on what's not really going on. Against creative accounting is argued that when companies manage earnings they damage their own business intelligence (Davin n. d.). Ethical Perspectives towards Creative Accounting Justices had faded from the accounting profession long time ago and this reflects the current state of morality in the society.

Ethics is defined as the discipline which deals with what is good and bad and with moral duty and obligation principles of conduct governing an individual or a group (Turner 1990). Managers are usually pin pointed as the culprits who lead to creative accounting as they may choose to abuse their powers

and exploit their privileged position to serve their private gain and this is done by managing financial reporting disclosures based on their self interest. However, it is argued that managers are benefited in being able to manipulate income between years so as to maximize their bonus entitlements.

It is reasonable to presume that those who negotiate managers' employment contracts anticipate such opportunistic behavior and reduce the compensation package accordingly, since, they, the managers have already been 'charged' for the opportunistic actions they must now engage in them in order to achieve the benefits they 'paid' for. The advocates of creative accounting take the teleological view that an action should be judged on the basis of the moral worth of the outcome.

It thus allow managers to choose between the alternatives permitted in 'loose' standards to achieve their desired end if they believe that it will benefit more parties. On the other hand, individualist who emphasizes individual liberty proposed that individuals should pursue their own interest. Therefore, it is ethical for the managers to manipulate the accounts in order to meet the requirements for pay increases or bonuses. The individualists see society as a composition of individuals. Hence, pursuing personal interest will ultimately improve their individual and collective welfare. A contrasting view is put forward by the opponents who hold the deontology view, which emphasizes on the moral value of the actual action. As creative accounting often involves concealing the truth from people who has the right to know, it is presumed to be immoral. Therefore, the opponents call for tighter standards to prevent such manipulation. In addition, proponents of <https://assignbuster.com/creative-accounting-and-ethics-flashcard/>

collectivism suggest that individuals should serve the interests of society when taken as a whole (Collectivism 2006).

Under this view, only those activities that increase profitability and shareholder value should be encouraged. Therefore, creative accounting based on explicitly motives of self interest is perceived as unethical while where the motivation was to promote the company, it is considered ethical. Conclusion From the collapse of Enron, Arthur Andersen and WorldCom, it seems obvious that a renewed awareness of ethical standards that have been the hallmark of our profession throughout its existence. Ethics is particularly pertinent as a foundation of the accounting profession.

If companies and regulators ever to learn from the collapses, it is essential that they look more closely at the relationship between auditors, managers and the company audit committee. The accountant roles have evolved from watchdogs to advocates and salespersons and auditing has become one of a number of services, including consulting and tax advice, in which accountants offer creative tax avoidance and financing structures services with a significant amount of fees. Accountants enable their clients to account for transactions under GAAP while reducing transparency and aggressively maximizing earnings and debt.

Many, if not most, companies have an ethics code but there is no guarantee that the company will be operated ethically. A code of ethics should represent all stakeholders and it should set the ethical climate of the company, offer guidance and go beyond strictly legal considerations. The code must be internalized and practiced, starting from the top down and it

must be enforced. An ethics committee or corporate ethics audits should be established to identify situations in which policies, controls or evaluations are inconsistent with the company's code of ethics (Hill, cited in Sage 2004).

Most people do not realize the costs and risks associated with earnings management. This may be one reason why it is allowed to continue.

Recommendations It is of course impossible to totally banish the act of creative accounting. Therefore, here are several proposed solutions in hope to reduce creative accounting practices (Amat, Blake & Dowds 1999; Boskin 2005). First, scope for choice of accounting methods can be reduced by reducing the number of permitted accounting methods or by precisely defining the circumstances in which a certain policy is allowed.

Secondly, abuse of judgment can be resolved by limiting the use of judgment and requiring consistency, meaning that if a company chooses an accounting policy that suits it in one year, it must continue to apply it in subsequent years no matter what may happen. Besides, artificial transactions can be tackled by a consistent compliance with the substance over form principle. Business events have to be looked at in the light of their content, not merely of their legal form. Next, the timing of transactions falls into the discretion of the management.

However, the scope to use this can be limited by requiring regular revaluations of items in the accounts so that gains or losses on value changes are identified as they occur, and thereby annul, or mitigate, the profits or losses that might occur only at the moment of the realization of respective business. The major problem that lies between the boards is the

failure to follow procedures that would encourage the management to be accountable for company performance. This could be improved by focusing on three areas.

Firstly is leadership where the independent directors must be a leader who does not also hold the position of chief executive officer. If the same person is holding the position of CEO and the chairman, a lead director should be chosen from the non-executive directors. Hence, these qualities will definitely ensure a strong bond of relationship with the audit partner (Lorsch 2002). It is also important cultivate independence in both the audit committee and the board. The auditors must ensure no commitment of unrevealed ties to the company by going through rotation every few years.

The audit committee should also forbid the management from hiring the same audit firm personnel for three years after the person has left the firm (Lorsch 2002). In addition, the information must also be improved. The committee should be fed with all information needed regarding the alternative GAAP methods that would project different accounting results and with figures outlining those differences. The reasons for the committee's acceptance of the management's and the auditor's recommendations should be disclosed in the financial statements.

Both the management and the auditors should discuss and resolve should there be any negative comments and the committee should assist in decide making whether changes are necessary or not (Lorsch 2002). Besides that, it is essential for the company directors to be honest and to exercise integrity within the company. If the directors possess honesty, there will be lesser

manipulation. As a result, the company will enjoy better reputation and respect will be given by the public. Not only that, this will also increase investor's confidence and the company will also be able to attract future investors.

As for integrity, it is an important tool to ensure that the company's operation is conducted in an ethical manner, in other words, it will project no harm to other parties. As a conclusion, creative accounting offers a great challenge to the accounting profession. The problem is an international one, with accounting policy choice being the most common contributor towards creative accounting. Accountants who accept the ethical challenge that creative accounting raise need to be aware of the scope for both abuse of accounting policy choice and manipulation of transactions.