THE IMPACT OF CREATIVE ACCOUNTING AND EARNINGS MANAGEMENT ON MODERN FINANCIAL REPORTING

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Abstract

The study examined creative Accounting earnings management, Professional and ethical issues in creative accounting, and their effects on modern financial reporting. In the light of these, the study define Creative Accounting, listed the types of Creative Accounting methods, highlighted the impacts of creative accounting on financial reporting and provided some examples of how accounts can be fiddled. The study reiterated the fact that Accountancy profession and practice are faced with the challenges of living up to expectation in the rapid advances in technology and business methods, and often times, the Accounting standards lag behind such growths and development. As such, research and education are needed to update the accountant, to develop his initiative and innovations to enable him cope with the challenging and growing business environment. There also the need for the review of the concepts of “True and Fair”, and materiality the as they affect published financial statements.

Introduction

Creative accounting and earnings management are euphemisms referring to accounting practices that should follow the letter of the rules of standard accounting practices, but certainly deviate from the spirit of these rules. They are characterized by excessive complication and the use of novel ways of characterizing income, assets or liabilities and the intent to influence readers towards the interpretations desired by the authors. The terms “innovative” or “aggressive” are sometimes used.

The terms as generally understood refer to systematic misrepresentation of the true income and assets of corporations or organizations. It could also be construed as window dressing of account, cooking of account, creating of figures or manipulating of figures being reflected in Financial Statement, (Bernstein, 1987). Creative accounting is at the root of a number of accounting scandals and many proposals for accounting reform-usually centering on an updated analysis of capital and factors of production that would correctly reflect how value is added.

Newspaper and Television journalists have hypothesized that the stock market downturn of 2002 was precipitated by reports of accounting irregularities at Enron, World Com, and other firms in the United States.

Having said this, the questions to ask are whether creative accounting has a relationship with Corporation’s Earnings? and does creative accounting have any relationship on financial reporting either positively or negatively. These are the ponderable questions the research has to address as we progresses.

One commonly accepted incentive for the systemic over-reporting of corporate income which came to light in 2002 was the granting of Stock options as part of executive compensation packages. Since stock prices reflect earnings stock options could be most profitably exercised when income is exaggerated, and the stock can be sold at an inflated profit.

According to Healy and Wahlen (1999) “earnings management” occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either
mislead some stakeholders about the underlying economic performance of a company or influence contractual outcomes that depend on reported accounting figures.

Earnings management usually involves the artificial increase (or decrease) of revenue, profit, or earnings per share figure through aggressive tactics. Aggressive earnings management is a form of fraud and differs from reporting error. Management wishing to show earnings at a certain level or following a certain pattern seeks loopholes in financial reporting standards that allow them to adjust the numbers as far as it is practicable to achieve their desired aim or to satisfy projections by financial analysis. These adjustments amount to fraudulent financial reporting when they fall outside the bounds of acceptable accounting practice.

Auditors need to distinguish between fraud and error by identifying the presence of intention. The main forms of earnings management are as follows;

- Unsuitable revenue recognition
- Inappropriate accruals and estimates of liabilities
- Excessive provisions and generous reserve accounting
- Intentional minor breaches of financial reporting requirements that aggregate to a material breach.

Conceptual Framework and Literature Review

Circumstances surrounding the business entity could cause operators of financial statements to indulge in creative accounting in order to meet up with the situational demand. Such circumstances can be briefly mentioned and explained thus:

- Agency Relationship
- Vagueness of accounting rules
- Advancement of technology and business methods
- Stewardship and Resource Allocation Conflict

Agency Relationship

This is a situation where the management is separated from the owner of business. In this case, there is pressure on management to report impressive results to stakeholders and other interest groups. On the contrary, a sole proprietor cannot give himself flattering results.

This relationship as originally set out by Alchian and Demsetz (1972) and extended by Jensen and Meckling (1976), individuals are seen to be rational, maximizing beings who seek to promote self interest above all else. Firms necessarily exist as a means of controlling the destructive opportunism of individuals especially those acting in the capacities of agents (Bernstein, 1987).

Under agency theory, cost not ethics provides the only restraint on the self interest behaviour of the agent. Since agents in this situation are constraint to impress investors and lenders and they are interested in high benefits, the agents are compelled to give an impressive report against their ethical values. Further, differences in interpretation of generally accepted accounting practices and standards create loopholes for the promotion of self interest.

Vagueness of Accounting Rules

The vague and flexible terms at which legislations and accounting rules are framed make them incapable to guide accounting practice. These standards and regulations only require consistent use and not standardization of accounting methods. The standards are vague because they only give impression of uniformity but allow a wide variety of accounting treatment for any particular accounting issue. The concepts of materiality and “true and fair view” leave room for subjective
judgement and manouvre in practice. Other concepts of these nature are conservatism principle and reporting inventory at lower cost and net realizable value.

**Advancement of Technology and Business Methods**

Growth in business methods is advancing faster than the legislations and prescribed accounting rules or guidelines. This leaves the professional with the only option of innovative methods to account for new accounting issues that arise.

**Stewardship and Resource Allocation Conflict**

Investors require impressive results of constant growth of a corporation in order to commit their resources. In this case, managers are enticed to adjust and give flattering results to reflect steady growth in order to obtain finance from investors. This amounts to creative accounting because in the actual sense, they are supposed to report on the actual performance no matter how unstable and unflattering the results may be.

**Methods of Creative Accounting**

Creative accounting exists in numerous ways due to the volume of estimates that require judgement and experience in drawing up a set of periodic financial statements. The following are few examples of methods of creative accounting.

**Income Smoothing**

According to Mathews, and Perera (1996), income smoothing is the process of deflating the reported profits of a business in good period and deferring them to loss making periods in an effort to portray a “stable income steam” over the years. This is possible because of the flexibility of matching concept, and investors prefer it as it purports a stable, strong and growing business. Also, that managers receive better in case of profit sharing scheme between managers and owners.

Income smoothing can be separated into “real” and “artificial” smoothing, (Igiril, 1967). In real smoothing, particular experience can be deferred to the following period e.g. advertising, while artificial smoothing is by way of shift in income through different policies from one period to the other e.g. depreciation method.

**Window – Dressing and Secret Reserves**

These involve the adjustment of financial statements of a company to achieve the maximum effect on the financial position at a particular date. This adjustment could be on any item on the balance sheet or profit and loss account. Example, a company may decide to inflate its sales by selling to its related company. This provision usually cushions the impact of such item on the profit when it actually takes effect, example provision for bad debt.

**Off Balance Sheet Financing**

This is a situation where total debts of a company increases but the increased borrowing is not reflected in the financial statements of the company. That implies better gearing of the company than it actually is to enable it acquires more loan or funds. In such cases, the subsidiary with low gearing may be used to borrow for the parent with high gearing and the inter company debts are eliminated at consolidation.

**Pooling Versus Purchases Methods**

Pooling is the accounting for a merger of two companies where there is no goodwill created which increases future income because no amortization of good-will is needed. Moreso, all pre and post acquisition reserves and earning are distributed to the share holders. These features make pooling of interest a useful tool for creative accounting in all forms of take overs.
The purchase method is unpopular because goodwill may be created and its amortization will
decrease profit in future years. Moreover, only its post acquisition profits are distributed to
shareholders.

**Determination and Disclosure Accounting Policies**

The Statement of Standard Accounting Practice I (SSAP I) requires that appropriate
accounting policies be adopted and disclosed in financial statements for the purpose of giving a true
and fair view. It also requires companies to disclose changes in accounting policies where such
changes are made in the reporting period. However, the reported profit figure and financial position
can become the result of the accounting policies adopted rather than of its trading.

**Other Methods**

Also, a host of psychological methods can be used to influence market behaviour such as
delaying bad news and speeding up good news, selective reporting of news and items and the
voluntary disclosure of qualitative disclosures to boost market confidence.

**Impact of Creative Accounting in Modern Financial Reporting**

The tendency to indulge in creative accounting is more in failed or failing corporations than in
healthy ones. There have been several studies to prove the above assertion. The studies that have
been carried out have ranged from income smoothing tendencies between management controlled and
owner-controlled firm, (Gilling, 1977), to whether failed companies are more prone to creative
accounting.

Driver and Mock (1975), in their study found that, compared to control group, failed or failing
companies tended to exhibit higher non compliance with status and professional standards. This is
consistent with Bernstein’s (1987) study which found that distressed firms were four times more
likely to make discretionary accounting changes which had a material effect on net income as
compared to healthy firms. The indication from the studies is that failing firms are more likely to
indulge in creative accounting in an effort to show more favourable balance sheet and income
statement ratios.

Further, Solomon (1991) found that a switch from accelerated depreciation method to straight
line method by firms is an indication that the firm has for some years, performed below normal stock
market, the intention therefore, is to report increasing income rather than the declining true picture.

In the pooling versus purchase methods of accounting for business combinations, the 1978
study by Kaplan and Mandeker found that companies reported higher earnings using pooling rather
than purchasing method of accounting for combinations. In the final analysis, creative accounting
cannot change the failing of business but will only cover it for a moment. Investors who are sensitive
to business reporting maneuvers can discern relevant to irrelevant information and would not be
misled by creative accounting.

Auditors work is made difficult and more complex by creative accounting. This is so because
its effects are subtle, interrelated and may spread through more than one financial period. Since audit
risk is higher in this circumstance, the Auditor needs to be more sensitive and put on inquiry. Such
indications of creative accounting which may result to material misstatement, when the management
deviates from the accounting principles, regulations and standards in an attempt to window-dress or
paint a brighter picture of the business, otherwise, the Auditor losses his integrity.

**Professional and Ethical Issues in Creative Accounting**

Accounting as a socially constructed discipline has no immutable laws and truths (Solomon,
1971). Its principles and guidelines/standards which are framed in broad terms, are subject to varying
interpretations especially between preparers and users of the financial statements. To unify these differences will amount to endless rules for each specific situation and reduces accounting function to a rule-following exercise without professional judgement aspect which is so important in a profession.

Given this situation, therefore, the Accountant’s professional duty and moral obligation to perform ethically and reflect the true and fair state of affairs of the company and uphold the integrity of the profession. In this way, the amount and level of creative accounting depends solely on the ethical attitude of the Accountant.

There has been legal professional move to control creative accounting. From the accounting discipline’s point of view, principles, concepts and doctrines are necessary for some form of coherence and uniformity to exist. To ensure adherence to the generally accepted principles or concepts or doctrines, some form of professional and legal guidelines or rules are required.

In Nigeria, there have been various legislations like the Company and Allied matters Act (CAMA) (1990) which laid down rules for disclosure in financial statements and where appropriate, the audit of the statements. In New Zealand, the financial reporting Act, 1993 now explicitly requires all financial and group financial statements of reporting entities to comply with GAAP.

If, in compliance with GAAP, the financial statements do not give a true and fair view of the matters to which they relate, the directors of the reporting entity must add such information and explanations as will give a true and fair view. (Sections II (i), II(2), 14(2). Legislations like the financial Reporting Act places responsibility on the Accountant or Auditor to ensure that Creative Accounting practices are minimized to give way to the true and fair view of the report.

These legislations are not without problems. Example, problems like the cost and length of litigation and the need to prove beyond reasonable doubt that Creative Accounting was involved may deter stakeholders from bringing a charge against a Creative Accountant.

Conclusion and Recommendations
The study defined creative accounting, listed the types of Creative Accounting methods and provided some examples of how accounts can be fiddled.

On the theoretical level, professional ethics is more relevant to curbing Creative Accounting than rigid rules for specific situations. Accountants should re-enforce their professional ethics to avert the audit risk and loss of professional integrity of Accountant to Creative Accounting.

Adoption of a conceptual frame work is another way of reducing Creative Accounting. The conceptual frame work defines and classifies Accounting elements, thus narrowing down different interpretations and treatments.

Recommendation
Empirically, results of studies have shown that reducing Creative Accounting is necessary because of its implications on management, Accountants and Auditors. Audit firms have been dragged to various litigations because of failure to detect material widow dressing of financial statements. For example, the case of Price Water/Cooper and Lybrand for the Collapse of Pan-Electric (1983) in Singapore. Nigerian in recent times (2009-date) faced or is facing the crises in the Banking Sector which led to the prosecution of some Directors, Managers and Accountants while declaring some who have been on the run wanted and if found, to face own prosecution with EFCC and the law courts. The Audit firms which audited such Banks are still facing doubt on their integrity and competence to have failed to detect such material frauds or errors.
The Accountancy profession is faced with the challenges of living up to expectation in the rapid advances in technology and business methods. Often, the Accounting standards lag behind such growths and development. Research and education are needed to update the Accountant, to develop his initiative, and innovations and to deal with challenging and growing business environment. Creative Accounting increases the scope and skills needed to prepare and audit a set of accounts. It most often take an insider’s information to detect off balance sheet financing. Therefore, Creative Accounting calls for the need to review the vagueness of the concepts of “true and fair” and ‘materiality’ as they affect published financial statements.

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