THE PARADOX OF CREATIVITY AND INVENTION IN ACCOUNTING AND THE PRINCIPLE OF CONSERVATISM

Henry Osimabale Auru
Business Education Department,
FCT COE Zuba Abuja.

Abstract

This study adopts the fundamental research approach to examine and explain theories, concepts and principles which shaped accounting to date. It also discussed the consequences which developments like the invention of creative accounting have on the principle of conservatism without making recommendation. Managers and chief executives are constantly under pressure to achieve greater returns on investment and a clean financial report at all cost. These desires lead to the invention of creative accounting aptly described variously as window dressing, cookie jar reserves and account engineering. These methods of accounting represent a departure from normal accounting norms and a negation of the principle of conservatism, a fundamental rule central to accounting paradigm. The question asked is, can the principle of conservatism be expunged or relaxed without inflicting irreparable damage to the profession, accounting paradigm and the business world it serves?

Keyword: Accounting, Growth, Paradigm, Reserves, Stewardship.

Accounting practice is as old as mercantile activities, dating back to the Babylonian era and the use of tablet by Egyptians as a tool for recording business transactions. Accounting has been aptly described as the language of business, (Alexander 2002, Adebayo 2011). Record keeping for accounting purpose was seen to have been in use since 4000BCE, with the basic purpose of accounting then and now, which is that of stewardship remain the same, (Edwards and Hermanson 2010). According to Welsch (1987), the first known treatment of the subject of accounting was written in 1494 in the

15th century, two years after the discovery of America. The basic foundation of accounting model was later laid by an Italian Monk and mathematician known as Fr. Luca Pacioli. The Model he developed was called double entry principle. The industrial revolution which gained momentum in the 17th and 18th centuries in Europe, coupled with the recognition of the limited liability status of corporate entities represent a significant turning point for the growth of industry and accounting practice.

The rivalry in the competitive market place and effort by management to achieve a satisfactory return on investment are drivers which constantly shaped the activities of firms and determines its ability to survive in the long term. In the constant struggle to survive, complex business decisions are precipitated with the accountant being looked upon by management to get the figures right on issues relating to income recognition, income tax, creation of reserves, assets and their valuation, liabilities disclosures, compensation plans, currency translation, equities, business mergers and business combination among others.

In dealing with issues such as those mentioned in the preceding paragraph, accountants are driven by the need to fulfill the demand by management, such as the desire to see rise in stock values, accountants therefore prepare financial statement relying on guides outside the realm of Generally Accepted Accounting Practice (GAAP). When the accountant embraces practices outside GAAP, rules and accepted practices by an international or local regulatory body from which the firm adopts its own accounting policies in preparing financial statement, the accountant is said to be engaging in inventing and use of creative accounting.

Creative accounting for itself is not bad, for it seeks only to look at things from the brighter side. It begs the question, why should accountants be constrained to be willing to report loses instead of profit? Why should asset be depreciated instead of appreciated? Why should provision be made for foreseeable foreign exchange transaction losses as opposed to gain? Questions such as these, attacks the fundamental principle of conservatism or prudency, along with other key principles on which a good accounting system or reliable financial statement is enshrined.

Within the last decade and a half, many international and local firms went into dissolution as a final chapter, having engaged in creative accounting to prep up the books without success. Enron is one renowned case in view that sparked a new debate on what amount to international best practice in accounting which spurred the urgency to come out with new rules for preparing accounts and financial reporting as a whole. A role which the International Accounting Standard Board (AISB) fulfilled through harmonizing global best practices into what is now called International Financial Reporting Standard (IFRS).

According to Adebayo (2011), IFRS is a modified version of International Accounting Standard (IAS). Nigeria like many countries within the international community framework adopted IFRS as the basis for preparing financial statement.

Theoretical and Conceptual Framework

Accounting defined: While there are several definitions of accounting, general consensus have been codified into key definitions such as that offered by American Institute of Certified Public Accountant (AICPA) as cited in Directorate of Distance Education Maharshi Dayanard University (DDEMDU) (2004), accounting were defined as the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of financial character and interpreting the results therefore. The step by step process involved suggests that accounting is a science, a science whose major focus revolves around money. The result of accounting process is so pervasive on decision making to the extent that managers, investors and even government take decision based on accounting information and conclusion reached after a careful and thorough appraisal process.

Accounting Theory:

Theorizing in accounting is a recent development that is still in its infancy, gaining attention towards the first half of the 20th century, (Eno 2002, DDEMDU 2004). Prior to this period, accounting practitioners relied on best practice as harmonized by practitioners of accounting all over the world. The adoption of best practice became the basis for formulating accounting theories which created gaps that encouraged the invention and use of different accounting techniques, including creative accounting. The use of different accounting technique lead to differences in accounting reports from one country to another (Adebayo, 2011). It was found from the foregoing, that relying on inductive approach, which is about theories derived from what accountants do as opposed to what they should do were the major factors encouraging the increasing use of new inventions such as creative accounting in recent times.

Principle of Conservatism or Prudency:

Conservatism as a principle is central to the paradigm of accounting. Conservatism is enshrined in accounting with the sole aim of fostering confidence in the use of financial report. Conservatism is characterized by:

- ✓ Situations where uncertainty exist,
- ✓ Willingness to recognize possible losses as opposed to income,
- ✓ Relying on historical cost values as opposed to market values.

According to Narayanan and Burkart (2005), conservatism is the differential verifiability required for recognition of profits versus losses. The authors explain the principle further to mean that when you are in doubt, the accounting alternative that is least likely to overstate assets and income should be chosen. A precaution taken having in mind that, the overriding interest of users of financial statement, particularly the external users and protecting them against possible abuse such as the paying of dividend out of capital, (Agboh 2007).

Creativity and Invention Theory: creativity is an age-long practice engaged in by man, a means through which changes are caused in the environment. Creativity connotes different meaning to different users, depending on the bias of the individual. Nelson (2010), opined that the term creativity first appeared as an English noun in 1875, though the word is used with a common understanding all over the world. Invention on the other hand, builds on ideas that work based on successful trials. Fry (2002), provides a hand on experience definition which in its simplicity effectively linked the key concepts as follows:

- ✓ Creativity is a fuzzy idea translated or made into a prototype that can be seen, touched, tested and appreciated by an audience,
- ✓ Invention on the other hand occurs when the result of a creative exercise which can be repeated and reduced to routine practice, while
- ✓ Innovation is said to have taken place when the new process or product gains commercial acceptance and causes the populace to change their behavior or procedure in doing things.

Though innovation in no way forms part of the current discuss, never the less, the connection provided by Fry makes it worthy of mention because it shows how the complete cycle between the three concepts are irrevocably linked, starting from creative effort to invention and finally to innovation. The opinion of Edwards and Butz (2009), confirmed that innovation is enshrined and conceived from creativity and invention. Creativity is easily likened to fine and applied art education, because, its products can be touched and appreciated in its diverse forms. Creativity represents human ingenuity in manipulating and reshaping the environment to best serve the need of man. When the concept is related to accounting, creative accounting can be perceived as the application of financial rules from its conception, including its limitations with a view of coveting values as much as possible to assets and liabilities within the shortest possible time, only because a legal lacuna or a gap exists in accounting paradigm.

The Link between Creativity, Invention and Conservatism in Accounting

According to Vladu and Matis (2010), creative accounting can be understood from two perspectives. It can be seen to connote invention of accounting principles and techniques to take account of changes in economic, social, political and business environments and off-cause, accounting practice. Creative accounting can be further understood to mean the use of questionable accounting methodologies designed to mislead, conceal or misrepresent facts about financial statements. This means that creative accounting has its good and bad side.

Creativity as a general rule as observed by Nelson (2010) as the key to economic growth, the decisive source of competitive advantage and the tool for producing wealthy and social regeneration. While this may be true, the unregulated use of creativity in accounting would weaken the doctrine of conservatism which has been proved from medieval agency accounting as essential to the success of accounting practice, (Alexander 2002). A similar view by Narayanan and Burkart (2005) showed that conservatism which is one of the pillars of accounting is gradually losing its essence as accounting rules come under increasing scrutiny and pressure, demanding more relaxation and sometimes, outright change of long held lexicon. Narayanan and Burkart (2005), cited the example of the IASB framework which recommended the use of the word "True and Fair View" to reflect the compliance of account as opposed to the suggestion by some accountants that the use of the word is akin to conservatism taken too far, hence, representing a bias on financial statement.

The conservatism approach by accounting theorist and practitioners rest on the premise that the preparation of account based on the least likely estimate of income or worst likely estimate of losses will caution users of financial statement to make better judgment. However, when proxied against the current strong demand for prospective future or market based values of assets and shares' values to influence investment decision, conservatism in accounting falls short of fulfilling this role, not even the slightest. Anyway conservatism cannot and will not fulfill this role because conservatism as an accounting principle was principally formulated to guard against the application of wanton account rule. This has constrained accountants to fill the information gap disregarding fundamental principles, by preparing financial statement on basis far removed and less aligned to the principle of conservatism.

From the evidences so far, it is observed that creative accounting when applied flagrantly without regards to fundamental norms is seen to be incompatible with the principle of conservatism. But as Nelson (2010) observed, creativity cuts across disciplines, ranging from business management, information technology, education, government and the sciences. Accounting must therefore embrace creativity because accounting is an active contributor to economic growth and this can only be achieved through the creative thought process while being mindful of the fact that accounting paradigm need to reinvent itself through the same process of creativity. To do otherwise will mean risking the possibility of the public perceiving accounting as a whole, as regressive in principle and in practice, if all it does is to enshrine limits which hinder economic growth.

In applying creative accounting to the preparation of financial statement, countries across the globe have had to decide for themselves the extent to which they can afford to relax the principle of conservatism without harming the firm. Narayanan and Burkart (2005) found that in applying the new IFRS accounting principle in Sweden, as far back as May 1st 2005, listed companies there were to revise their balance sheet every quarter with regards to revaluation of disclosed assets and liabilities. This implies that the value of assets and liabilities were probably higher or lower than reported, meaning again that somehow the principle of conservatism has to be flexed to achieve the kind of reporting required under the country specific rule.

Creative accounting was used in Nigeria banks to report favorable earnings growth and to give a positive picture of a solvent and strong Deposit Money Banks (DMBs). This state of affairs were achieved by accruing interest and round tripping fund from one bank to another, taking advantage of differences in financial reporting dates. The discovery and subsequent halting of same lead to the widespread incidence of distress and eventual failure of DMBs in the financial system. Small and medium scale firms in the manufacturing sector too also engage in some subtle measure of creative accounting through manipulating and capitalizing expenses and valuing assets disproportionately so as to create reserves, which can later be used as an excuse to reward management for perceived favorable performance. Narayanan and Burkart (2005), concluded that much of the event which led to the corporate scandals around the globe are due mostly to the abuse of conservatism principle. Put differently, it is the failure to apply the principle of conservatism in preparing financial statement for reporting purposes.

The invention and excessive use of creative accounting gave rise to the incidence of high profile corporate scandals such as that of Enron and WorlCom. It was found that WorldCom capitalized cost of leasing from other companies instead of expensing it in the year in which they occurred. In the case of Enron, the abuse of the conservatism principles took the form of pricing of derivatives using future pricing method which led to higher valuation and a lucrative bonus for the managers. Creative accounting clearly leads to a situation where financial statements are prepared to achieve a predetermined purpose by creating and presenting a misleading picture. Investors who based their decisions on such report end up suffering huge financial losses in the long term. Corporations such as Enron and WorldCom collapsed as a result of the falsehood and series of account manipulations taking advantage of weakness in accounting standard leading to the relegation of conservatism principle to the background.

Conclusions

The upholding of the principle of conservatism in the preparation of financial statement for reporting purpose is in the best interest of those who rely on it to make investment and divestment decisions. It is also seen to lower or obviate agency cost and makes the work of regulators a lot easier. Accounting paradigm can only improve its value added service through constantly being able to align itself to economic and social changes in a technologically advanced and converging society. Practitioners of accounting and accounting theorists must therefore rely on creativity and invention to improve its effectiveness and efficiency, so that improved qualitative and timely financial information is readily available to users of financial information. In doing so, practitioners should restrain themselves from the tendency to exploit creativity and invention in accounting, such as creative accounting in favor of management or to some selfish end in total disregard to the fundamental guiding principle of conservatism on which confidence reposed on financial statement rests.

References

Adebayo, P. A. (2011). *IFRS practical implementation guide for preparation & presentation of financial statements.* Nigeria, Abuja: White Knight Consulting.

Agboh, I. C. (2007). ***Fundamental approach to financial accounting***. Nigeria, Enugu: El'Demak.

Alexander, R. J. (2002). *History of accounting. association of chartered accountants in the United States,* New York. Retrieved, 19th May, 2015.

DDEMDU (2004). Accounting theory paper 8. New Delhi: Excel Books PVT Ltd. www.mdudde.net/ Retrieved, 19th May, 2015.

Edwards, A. & Butz, B. (2009). What is the difference between Invention and innovation? www.unco.edu/. Retrieved 19th June, 2015.

Edwards, J. D. & Hermanson, R.H. (2010). Accounting principles: A business perspective. (Vol 1, Financial Accounting). Jacobs Foundation, Zurich, Switzerland.www.saylor.org/. Retrieved, 19th May, 2015.

Eno, I. (2002). *The Place of Research Ing. (SIC) Accounting and finance*. Being a contribution contained in Research Design and Implementation in Accounting and Finance. Nigeria, Bennin: University of Benin Press.

Fry, A. (2002). Creativity innovation and invention: A corporate inventor's perspective. The creative problem solving group, Inc. CPSB'S Communiqué, 13. P.1-5. www.cpsb.com/. Retrieved 19th May, 2015.

Narayanan, S. & Burkart, M. (2005). The role of accounting conservatism in a well-functioning corporate governance system. **MPRA**. http://mpra.ub.uni-muenchen.de/4458/. Retrieved, 19th May, 2015.

Nelson, C. (2010). The invention of creativity: the emergence of a discourse. Research Online @ ND, University of Notre Dame Austrialia. http://researchonline.nd.edu.au/arts_article/30. Retrieved 19th May, 2015.

Vladu, A. B & Matis, D. (2010). Corporate governance and creative accounting: two concepts strongly connected? Some interesting insights highlighted by constructing the internal history of a literature. Annales Universitatis Apulensis Series

Oeconomica, 12(1), 2010. www.oeconomica.uab.ro/. Retrieved, 19th May, 2015.

Welsch, G. A., & Short, D. G. (1987). ***Fundamentals of financial accounting*** (5th Ed.) USA: Rechard B. Irwin.