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CREATIVE ACCOUNTING – AN UNETHICAL METHOD OF FRAUDULENT REPORTING

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Abstract

Creative accounting is an essential and critical topic in the business world. This concept is strongly related to the ethical standard of accounting and general ethics. However, it is evident that the extent of using creative accounting in preparing financial reports has violated all known ethical standards. Companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. To achieve this objective, accountants make manipulation in the financial statements without considering justice, fairness and morality. As a result Creative accounting practice has been increasing in recent years. However, it is evident that the extent of Window-dressing (Creative accounting) of company's financial statements has greatly violated all known ethical standards.

Key Words: Ethics, Accounting ethics, Creative accounting, Earnings smoothing, Financial engineering, Cosmetic accounting, Code of ethics, Bangladesh Accounting Standards (BASs).

1. Introduction

Financial statements provide information that is used by the interested parties to assess the performance of managers and to make economic decisions. Users may assume that the financial information they receive is reliable and fit for its purpose. Accounting regulation attempts to ensure that information is produced on a consistent basis in accordance with a set of rules that make it reliable for users. However, communications between entities and shareholders may be deliberately distorted by the activities of financial statements preparers who wish to alter the content of the messages being transmitted. This type of distortion is often referred to as 'Creative accounting'. This Creative accounting concept may be a blessing or a curse. It is a blessing when it is used to treat extraordinary item in which way that is beneficial for all stakeholders and to introduce something new to refine the accounting system and enrich the Accounting knowledge. It becomes a curse when unethical elements make intrusion. But in real world situations we see that creative accounting practice is a curse, rather than a blessing, and therefore undesirable. The main purpose of this cosmetic accounting is to attract unsuspected investors by presenting misleading or deceptive information.

The term creative accounting can be defined in a number of ways. Initially we will offer this definition: 'a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business'. Creative accounting is referred to as income smoothing, earnings smoothing, financial engineering and cosmetic accounting. In Europe the preferred term is "Creative accounting".

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So, we can say that creative accounting involves a transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulation. In a word we can say that creative accounting is a process of “being legally illegal”. Now a day’s creative accounting is a crucial and important issue in the world of accounting. This is now widely used in the accounts of the company. By using this, some of the companies become successful and some of the companies suffer.

2. Literature Review

The concept of creative accounting usually used to describe the process through which the accounting professionals use their knowledge in order to manipulate the figures included in the annual accounts. Creative accounting has been defined as “the art of faking a balance sheet”.

According to Ian Griffiths, “Every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest contrick since the Trojan horse…In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting” (1986:1). Michael Jameson argues that the accounting process consists of dealing with many matters of judgment and of resolving conflicts between competing approaches to the presentation of the results of financial events and transactions…..this flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities – practiced by the less scrupulous elements of the accounting profession- have come to be known as ‘creative accounting’. (1988:7-8)

Kamal Naser argues that “Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers’ desire by taking advantage of the existing rules and/or ignoring some or all of them. (1993:2). Barnea et al. (1976) observes that “Is the deliberate dampening of fluctuations about “some level of earnings considered being normal for the firm”. According to Merchant and Rockness (1994), “Is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental”. Copeland (1968) argues that “Involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared”.

Schipper (1989) observes that ‘creative accounting’ can be equated with ‘disclosure management’, ‘in the sense of a purposeful intervention in the financial reporting processes. Two features are common to all writers:

1. They perceive the incidence of creative accounting to be common.

2. They see creative accounting as a deceitful and undesirable practice.

The creative accounting appeared in the Anglo- Saxon literature in the 1970s, most often in the study about the bankruptcy of enterprises and those written by

Watts and Zimmerman (1978, 1986, and 1990). According to Colasse, creative accounting is defined as a cumulus of accounting information practices, at the limit of legitimacy, practiced by some economic entities in order to beautify the image of the financial position and the economic- financial performances.

A complex version is provided by Naser (1993) in whose opinion, "Creative Accounting is: 1) the process through which, due to the existence of some breaches in the rules, accounting figures are manipulated and, taking advantage of the flexibility, they choose those measurement practices allowing the transformation of the synthesis documents from what they are supposed to be into what the managers want; 2) the process through which the transactions are structured in such a manner that it allows the "production" of the "desired accounting result'. Merchant and Rockness (1994) define creative accounting as any action taken come from the management which can distort the profits and which is not a consequence to the economic reality, it actually represents the privilege of the financial engineering.

3. Objectives and Methodology of the study

3.1 Objectives of the study

The research objective is to determine whether creative accounting is a legitimate business tool and whether it is ethical to use creative accounting concept as business tool or it is a problem that can never be solved. To fulfill the objective, the study will focus on the following supportive objectives:

- ❖ To gain a clear understanding of the concept of creative accounting
- ❖ To gain knowledge about technique of creative accounting
- ❖ To know about accounting ethics
- ❖ To obtain solutions of the problems.

3.2 Methodology of the study

This study includes both primary data (data gather and assembled specifically for the research project at hand) and secondary data (data has been previously collected for some project other than the one at hand). In the process, a wide range of published books and internet regarding theories and past empirical studies on creative accounting have been consulted. Data have also been collected via personal interviews and questionnaire.

The study was carried out by both field survey as well as secondary data analysis. Data found by the survey were aligned with the secondary data to find out the information. In this study, we examine the problem of this study (related to a few issue only), by a surveying and analysis of experts' opinions. These experts are -

(i) Chartered Accountants of Bangladesh

(ii) University Teachers of Accounting & Information Systems

The issues addressed are:

(1) Whether creative accounting has long been in practice,

(2) Whether creative accounting is a legitimate tool,

(3) Whether creative accounting is a blessing or curse,

(4) What possible measures could be adopted to stop the practice of creative accounting, and

(5) Important code of ethics should be included in accounting education,

(6) Whether the prospectuses issued by the companies ignore "notes to financial statements" as well as the information required by BAS-1, especially with reference to disclosures and accounting policies.

4. Motives and Opportunities for Creative Accounting

4.1 Motives of Creative Accounting

The main motives are as follows:

a. *Smoothing of income:* Companies generally try to show a steady trend of growth in income and profit rather than to show volatility in profit year to year. It can be done by making unnecessary high amount of provisions for liability and against asset value in good years. This can be used in bad years to make adjustments.

b. *A variant on income smoothing is to manipulate profit to tie into forecasts:* Companies normally try to report their performance in such way that they will be able to fulfill their targets or forecasts. As result they will be able to attract potential customers.

c. *Income-boosting accounting policy:* Company directors may keep income-boosting accounting policy change in hand to distract attention from unwelcome bad news. To achieve this goal this is a necessary way.

d. *Maintain or boost share price:* Maintaining or boosting share price both by reducing apparent levels of borrowing can be done through creative accounting. It makes companies less risky and the appearance of a good profit trend. This helps the company to raise capital from new share issues, offer their own shares in takeover bids, and resist takeover by other companies.

e. *Insider dealing:* If the directors engage in insider dealing then they use creative accounting to delay the release of information for the market, thereby, enhancing their opportunities to benefit from inside knowledge.

f. *Option to choose accounting method:* The management or directors are free to choose accounting method. This motivates to use creative accounting in any critical situations. For example, in case of taking loan from lenders, there may be some restrictions. The management can avoid these restrictions by accepting alternative accounting methods and by using creative accounting.

g. *Bonus scheme:* If the directors' bonus scheme is linked to profits or to the company share price then the directors will be motivated to present accounts that will impress the stock market or profits. Where a bonus is based on reported profit, the scheme often stipulates that the bonus is a percentage of profit above minimum level, and is paid up to a maximum level.

Thus:

1. *Profit position:* If the profit figure is between the two levels, then, directors will choose accounting methods that lift profit towards the maximum.
2. *Low profit:* If the profit is below the minimum level directors will choose accounting methods that maximize provisions made, so that in future years these provisions can be written back to boost profit.
3. *Higher profit:* Similarly if the profit is above the maximum level directors will seek to bring the figure down to that level so that the profit can be boosted in later years.
4. *Profit sharing arrangement:* Profit sharing arrangement may affect the accounting methods. To get profit share directors and management manipulate the reported profits. To do this they accept alternative accounting policies.
5. *Taxation:* Taxation may also be a crucial factor in creative accounting. In those circumstances where taxable income is measured by relation to the accounting figures, at that situation directors manipulates accounts.
6. *New managers:* When a new manager takes over responsibility for a unit there is a motivation to make provisions that ensure that any losses appear as the responsibility of the previous manager.

4.2 Opportunity for Creative Accounting

There is lacking or gap or unnecessary benefits in accounting methods that make opportunities for creative accounting. Accounting method makes opportunities for creative accounting in the following ways:

i) *Choice of accounting method:* A company is free to choose between different accounting methods.

   In many cases, a company is allowed to choose between a policy of writing off development expenditure as it occurs and amortizing it over the life of the related project. A company can therefore choose the accounting policy that gives their preferred image.

ii) *Bias estimates and prediction:* There are some entries in the accounts involve an unavoidable degree of estimation, judgment, and prediction. In some case, such as the estimation of an asset’s useful life made in order to calculate depreciation, these estimates are normally made inside the business and the creative accountant has the opportunity to err on the side of caution or optimism in making the estimate.

iii) *Enter into artificial transaction:* Artificial transaction can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. This is done by entering into two or more related transaction with an obliging third party. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a ‘sale and leaseback’ can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

iv) *Timing of genuine transactions:* Genuine transactions can be timed so as to give the desired impression in the accounts. As an example, suppose a business has an investment of Tk. 1 crore at historical cost which can easily be sold for Tk. 3 crore, being current value. The managers of the business are free to choose in which year they sell the investment and so increase the profit in the accounts.

v) *Dearth of regulation:* Some areas are simply not fully regulated. For example, there are very few mandatory requirements in respect of accounting for stock options. Accounting regulation in some areas are limited. For example, the recognition and measurement of pension liabilities and certain aspects of accounting for financial instruments.

5. Ethical Perspective

5.1 Overview

Creative accounting is a matter of approach not an objection per se. However, when unethical elements make intrusion, the resultant accounting details become anything, but true and fair. Creativity in such context is like referring to a half glass of water as half full instead of describing it as half empty. While both statements are factually correct. They paint different pictures and thus convey different images. Creativity in company accounting may arise under at least three different financial market conditions.

First, When a company floats its shares to attract investors to subscribe to such shares either at par or at a premium, depending on the financial market evaluation of the company's future prospects.

Second, When the company whose shares are already listed in a stock exchange, wants to paint an attractive picture of its financial conditions so that the shares may be quoted at a premium.

Finally, A company having its shares listed in the stock exchange may declare and pay high dividends based on inflated profits through overvaluation of assets, undervaluation of liabilities and change in systems of stock valuation that may boost the image of the company at least in the short run. Unethical considerations in creative accounts have developed to such depths that terms like fraud audit and forensic accounting have gained currency and are becoming new professions.

5.2 Creative Accounting from Negative Viewpoint

The term creative accounting is widely used to describe accepted techniques which permit corporations to report financial results that may not accurately portray the substance of their business activities. Creative accounting is recognized as a synonym for deceptive accounting. Creative accounting methods are noteworthy because this remains in use as generally accepted accounting principles, even though they have been shown to be deceptive in many cases.

H. Bosch (1999) refers to a situation with regard to creative accounting in the following ways:

- It was common for the so- called entrepreneurial companies to include capital profits from the sale of properties or shares…as operating profits…on the ground that speculation was a major element in their business.
- Some of the companies booked unrealized capital gains as operating profit.
- Some of the transactions which gave rise to these "profit", were done with business associates or even within the same group of associated companies.
- The values put on the assets "sold", often looked very suspicious, with secret put and call option arrangements.
- Sometimes allowing the "buying" company to transfer the asset back to the seller at a later date- in some cases just after balance sheet date.
- It was common for companies to include their "shares" of the net profits of associated companies in their own results.
- There were many company that were not consolidated into group accounts to keep debt off a group's balance sheet and thus to give a misleading appearance of its capital structure.
- Associated companies and interposed trusts were also used to conceal other favorable information from the eyes of investors.

5.3 From a Positive Viewpoint

It may seem that creative accounting connotes invention of accounting principles and techniques to recognize changes in economic, social, political and business environments. But real world experience reveals that it is in most cases practiced in an undesirable way to attract investors by presenting an exaggerated, sometimes misleading and deceptive state of an organization's financial affairs.

5.4 Causes and Effects of Creative Accounting

The real causes of creative accounting lie in the conflicts of interest among different interest groups. For example, managing shareholders' interest is to pay less tax and dividends. Investor-shareholders are interested to get more dividends and capital gains. Country's tax authorities would like to collect more and more taxes. Employees are interested to get better salary and higher profit share. But creative accounting puts one group or two to advantageous position at the expense of others.

The obvious effects of creative accounting:

i) There are companies listed on the stock exchange, which show inflated profit and better financial position in their creative accounting statements to attract investors; this creation of accounts just misguide and create confusion.

ii) Some company prospectuses may not always depict the reality of the financial positions of the listed companies.

iii) Processes adopted for created accounting systems may hold out untrue hopes to investors for a shorter period, but cannot continue to succeed for a longer period.

iv) Ultimately, the concerned companies listed in the stock exchange collapse and the investors lose confidence in them and stock market.

v) Examples of victims of creative accounting are many, such as “Enron”, “WorldCom”, “Brent ford”, “Polly peck”, etc. in recent times.

5.5 What Say Accounting Ethics?

Ethical values are the foundations on which a civilized society is based on. Without them the civilization collapses. In business, the purpose of ethics is to direct businessmen and women to abide by a code of conduct that facilitates public confidence in their product and services. Ethics must and should be taught. People are not born with the desire to be ethical or be concerned with the welfare of others. Accounting ethics is both a normative and descriptive discipline. When we talk about accounting ethics, we should keep in mind and link the term with creative accounting, earnings management, misleading financial statements and many more.

Due to the diverse range of accounting services and recent corporate collapses, attention has been drawn to ethical standards accepted within the accounting profession. These collapses have resulted in a widespread disregard for the reputation of the accounting profession. To combat the criticism and prevent fraudulent accounting regulations, remedies for improved ethics among the accounting professional should have been developed. The nature of work carried out by accountants and auditors requires a high level of ethics. Shareholders, potential shareholders, and other users of the financial statements rely heavily on the yearly financial statements of a company as they can use this information to make an informed decision about investment. They rely on the opinion of the accountants who prepared the statements, as well as the auditors that verified it, to present a true and fair view of the company.

So, in brief,

i) Accountants should be strictly adhered to professional ethics.

ii) Accountants should have an obligation to the organizations they serve, their profession, the public, and themselves to maintain the highest standards of ethical behavior.

iii) They should have a responsibility to be competent and to maintain confidentiality, integrity and objectivity

iv) Accountant should not allow personal prejudice or bias to override objectivity.

v) At time of conveying information in financial statements, the accountants must maintain impartiality.

vi) An accountant has to be free from prejudice or bias.

vii) An accountant should satisfy herself or himself that none of her or his acts is influenced by personal bias.

7. Analysis Based on Expert Opinion Survey

Creative accounting is a tool that is used for the benefit of companies, shareholders, stakeholders and sometimes to prevent managers themselves. So there are many specific and certain reasons scope for creative accounting.

7.1 Analysis of the study

The issues and respondents' opinions are analyzed in the following paragraphs:

Table 1: Responses as to whether creative accounting has long been in practice

Respondents' Responses	Chartered Accountants	University Teachers of Accounting	Total
Yes	15 (75%)	7 (70%)	22 (73%)
No	5 (25%)	1 (10%)	6 (20%)
Don't know	----	2 (20%)	2 (7%)
Total	20 (100%)	10 (100%)	30 (100%)

Table 1 shows that a substantial majority of Chartered Accountants (75%) and University Teachers of Accounting (70%), that is, overall 73% of all respondents taken together are of the view that creative accounting has long been in practice, while only 20% of University Teachers of Accounting seem to have no idea about how long creative accounting has been in practice.

Table 2: Responses as to whether the prospectuses issued by the organizations ignore "notes to financial statements" as well as the information required by the BAS-1, especially with regard to disclosures and accounting policies

Respondents' Responses	Chartered Accountants	University Teachers of Accounting	Total
Yes	16 (80%)	9 (90%)	25(83%)
No	4 (20%)	1(10%)	5 (17%)
Don't know	----	----	----
Total	20 (100%)	10 (100%)	30 (100%)

It is evident from Table 2 that majority of Chartered Accountants (80%), University Teachers of Accounting (90%) and an overall (83%) of all the respondents taken together agree that prospectuses issued by the companies tend to ignore "note to financial statements" as well as information required by BAS-1, especially as regards disclosures and accounting policies.

Table 3: Responses as to whether creative accounting is a legitimate tool

Respondents' Responses	Chartered Accountants	University Teachers of Accounting	Total
No	16 (80%)	8 (80%)	24 (80%)
Yes	4 (20%)	1 (10%)	5 (17%)
Don't know	----	1 (10%)	1 (3%)
Total	20 (100%)	10 (100%)	30 (100%)

Table 3 shows that quite majority Chartered Accountants (80%), University Teachers of Accounting (80%) and an overall (80%) of all the respondents, regarded that creative accounting is not a legitimate tool. While only 10% of University Teachers of Accounting seems to have no idea about whether creative accounting is legitimate tool or not.

Table 4: Responses as to whether creative accounting is blessing or curse for the organization

Respondents' Responses	Chartered Accountants	University Teachers of Accounting	Total
Curse	16 (80%)	9 (90%)	25 (83%)
Blessing	4 (20%)	1 (10%)	5 (17%)
Total	20 (100%)	10 (100%)	30 (100%)

Table 4 shows that quite majority of Chartered Accountants (80%), University Teachers of Accounting (90%) and an overall 83% of all the respondents, regarded creative accounting as a curse, while a small proportion of all of the two groups of respondents considered creative accounting a blessing for the companies.

Here chartered accountant says that, if it brings well being for overall organization without harming the interest of any group within the organizations, then it is a blessing for the organization. But in general, it is a curse for the organization.

Table 5: Responses as to whether important code of ethics should be included in accounting education or not.

Respondents' Responses	Chartered Accountants	University Teachers of Accounting	Total
Yes	20 (100%)	10 (100%)	30 (100%)
No	----	----	----
Total	20 (100%)	10 (100%)	30 (100%)

Table 5 shows that 100 percent respondents of all the study groups (Chartered Accountants and University Teachers of Accounting) have recommended that the moral virtues of honesty, integrity and incorruptibility should not only be included in the accounting curriculum and taught in tertiary institutions, but should also be instilled into the very fiber of students' character.

With respect to providing suggestions to stop the unethical practice of Creative Accounting, 100 percent respondents of all groups under study (Chartered Accountants and University Teachers of Accounting) suggested the following measures:

1) Introduction of forensic accounting.
2) Punitive measures by national accounting bodies, courts and government.
3) Giving much importance to ethical codes by the accounting professions.
4) Prevention of fraudulent financial reporting by all means.

5) Accounting education should be conducted from ethical point of view rather than rule and form based.

7.2 Findings of the Study

Almost all the researchers and experts give opinion that creative accounting is cosmetic accounting. Its result in most of the cases is bad. Through window dressing it deprives many parties to benefit one party. On the other hand, the shareholders have right to know the actual information, but because of creative accounting they are deprived from that. That is not fair and ethical, so experts say that the creative accounting should be protected.

From the consequence of the creative accounting we see that these bad things occurred, because there is lacking of ethical value in the mind of accountants. If they have adequate ethical values these things could not be occurred and they could protect these unethical activities. Since they have engaged in fraudulent accounting without considering ethics that results the company to become bankrupt and the accountants become fired and arrested. So the accountant should follow ethics in his professional task strictly.

From the analysis of expert views, it is found that creative accounting has long been in practice. The example of practice is available, such as Brentford, Enron, etc. In most of the cases it is used with bad intention. The victims of the bad use of creative accounting are WorldCom Inc., Enron, etc. Sometimes it is used with good motive. Then it is good sign. When it is used with good motive and then is a blessing and if it is used with good motive, it can improve the accounting standard. The analysis also shows that the companies ignore notes to financial statement that is required by IAS-1. We also see that creative is not a legitimate tool and it is considered as a curse in most of the cases. So, the accounts should be protected in any way and to do that ethics should be taught to accounting students and ethics should be included in the curriculum in accounting.

8. Conclusion and Recommendations

This crucial concept of creative accounting is strongly related to the ethical standards of accounting and general ethics. The study will provide a number of benefits, if we get any way to prevent unethical use of creative accounting through appropriate measures in future. If unethical use of creative accounting is prevented then the rights of stakeholders will be established.

It is clear from the discussion that creative accounting practice is existed and many of the companies are the victims of that. So to detect and prevent the pitfalls of creative accounting, punitive measures have to be taken by national accounting bodies, courts and government. Ethical codes need to be given much importance by accounting profession. Accountants need to understand ethical codes in proper perspective and follow them accordingly. Students of accounting also should learn all these by heart.

Fraudulent financial reporting needs to be prevented by all means. Misrepresentation of facts and falsification of accounts have to be treated as great offences and dealt with strictly. Every accountant should keep in mind that ethical conduct and accounting education are essential to modern society, the business world and the accounting profession. The liability of an accountant for his acts and faults is not restricted to his immediate client alone but extends to third parties who rely upon his professional advice. Therefore the accountant needs to take all care to ensure that his advice is not incorrect or misleading. To ensure that there is necessity for accountants to adhere strictly to the code of professional ethics, can hardly be overemphasized.

So, in short, we recommend that-

a) Ethics should be followed by accountants strictly.
b) The Accountants should understand the professional ethics clearly.
c) They should not be biased to any party.
d) They consider accounting profession as a holy profession.
e) Ethics should be taught to accounting students.
f) Ethical course should be included in the curriculum in the accounting.
g) Introduction of forensic accounting.
h) Giving much importance to ethical codes by the accounting professionals
i) Prevention of fraudulent financial reporting by all means.
j) Accounting education should be conducted from ethical point of view rather than from rule and form based view.
k) Punitive measures by national accounting bodies, courts and government should be taken.

So, core speech is only ethics can protect all fraudulent activities in all sectors.

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