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Determinants Of Creative Accounting

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ABSTRACT

The resurgence of creative accounting has become an issue of concern globally. The conflicts of interest among different interest groups amongst others represent the real causes of creative accounting. This study focused on determinants of creative accounting to determine whether the identified causes such as employees and top management compensation package tied to performance, loophole in GAAP, flexibility in accounting standard, agency rating, shareholders' demand for regular dividend and improved earning, actually encourage creative accounting or that they are a product of intuition that have no empirical basis. The study made use of primary survey data sourced through the administration of questionnaires on 200 respondents using random sampling. Three hypotheses were tested using Chi square test statistic. The three null hypotheses were rejected. The researchers therefore conclude that the identified factors actually correlate with creative accounting. It is recommended amongst others that the policy makers and regulators should ensure the bridging of the gap and loopholes inherent in GAAP and accounting standards. Investing public should also be enlightened to frown at creative accounting under any guise because of its remote consequences on their investments.

Keywords: creative accounting, financial manipulation, fraudulent reporting

Determinants Of Creative Accounting

Introduction

Creative accounting cannot be separated from information disclosure and financial reporting since it is usually carried out in an attempt to report financial information in such a way that makes it look better than it would have been if reported objectively (Izedonmi, 2006). Accurate, relevant and reliable disclosures are seen as a means of enhancing corporate image, reduce cost of capital, and improve marketability of shares. It also facilitates the acquisition of long term fund, enables management to properly account for the resources put in their care, and also acts as a spur to the growth and development of capital market.

The accounting profession and the business world at large have experienced an unimaginable shock occasioned by manipulation of records and financial statement tagged 'creative accounting', 'window dressing', 'earnings management', and 'balance sheet engineering'(Izedonmi, 2006). Creative accounting in an unimaginable dimension has led to the fall of companies' world over. Like in the scandal cases of Cadbury Nigeria Plc, Nigerian banks failure (2005 and 2009), Enron in the United States of America and World Com in the United States of America amongst others. Thus, the ethical values of the accounting profession are being tarnished by questionable accounting practices

Creative accounting is characterized by excessive manipulation, complications and the use of 'novel' ways of reporting income, assets and liabilities. According to Osaze (1998:32) creative accounting can be seen as the manipulation of normal accounting and financial statements by moving accounts around, changing their locations and subheads, redefining accounts and even inflating accounts in order to present an attractive picture of the state of health of an organisation or a rosier one depending on the objectives being pursued". Fortin (2008) perceived creative accounting as "using the flexibility within the accounting process to present a preferred picture of the firm at a point in time".

According to Amat, Blake and Dowds (1999:6) creative accounting is defined as "a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business. A strict application of this definition makes no moral judgment about creativity in accounting, as in every other creative pursuit, crime, and creativity independent of each other. According to Oxford Advanced Learner's Dictionary creative accounting is defined as a way of doing or presenting the accounts of a business that might not show what the true situation really is.

A lot had been said on creative accounting, its causes and possible future impact on organization(Sen and Inanga, 2004:5; Adegbaju and Umoren, 2002:165). However, researchers in Nigeria (Osaze, 1998, Adegbaju and Umoren, 2002) have concentrated more on the impacts or implications of creative accounting with little or no effort to determine whether some of the factors so identified as the causes of creative accounting actually impact significantly on creative accounting. Accordingly, the objective of this study is to determine empirically whether some hitherto identified factors such as employees and top management compensation package tied to performance, loophole in GAAP, flexibility in accounting standard, agency rating, shareholders' demand for regular dividend and improved earning are the root causes of creative accounting and

in GAAP, flexibility in accounting standard, agency rating, shareholders' demand for regular dividend and improved earning are the root causes of creative accounting and how best to make them a thing of the past. This has important implications for regulators and policy makers who wish to encourage transparent reporting practices.
The paper is divided into four sections. The foregoing section introduces the paper, section two deals with literature research the determinants of creative accounting while section three, four and five deals with research methodology, analysis of the result and recommendation and conclusion respectively.

Literature review

In the words of Merchants and Rockness (1994) creative accounting is an action on the part of management which affects reported income and provides no true economic advantage to the organisation and may in fact, in the long run, be detrimental. The term creative accounting is widely used to describe accepted accounting techniques, which permit corporations to report financial results that may not accurately portray the substance of their business activities. Creative accounting is recognised as a synonym for deceptive accounting which remains in use as Generally Accepted Accounting Practice (GAAP), even though they have been shown to be deceptive in many cases. The implication of these definitions is that creative accounting is not necessarily a departure from the standard of accounting and financial reporting as stipulated in the accounting standard or GAAP but an indication that give room for fraudulent, aggressive reporting and financial misrepresentation that is not in the best interest of the users of financial statements and the going concern of any organisation.
According to Asein (2002:28), the international Accounting Standard (IAS) now known as International Financial Reporting Standard (IFRS) allows management of corporate organisation to choose and consistently apply any financial reporting framework they desire. All accounting principles applied in the generation of financial statements must be disclosed including, if need be, the reason for changing accounting policies. In particular, IAS 5 information to be disclosed in financial statements call for disclosures of "significant" inter-company transactions and investments in and balance with group and associated companies and with directors. The word "significant" as indicated by the standard is a loose and ambiguous provision that directors can hide under to "window dress" financial statements. While some researchers are of the opinion that creative accounting are deception (Metcalf 1977), manipulation (Amat et al, 1999) may in the long run be detrimental (Merchant and Rockness (1994). Creative accounting on the other hand could be a blessing in some respect.
Accounting to Sen and Inanga (2004: 5) creative accounting is a blessing where something new is introduced to refine the accounting system and therefore becomes an addition to the existing stock of accounting knowledge. It is used in sale and leaseback of assets, valuation of human resources, warding off mergers and acquisitions (Osaze 1998: 32). However, these researchers are of the opinion that since creative accounting involves financial information in such away that makes it looks better than what it would have been objectively reported, this is usually detrimental to the shareholders and may adversely affect the going concern assumption of reporting entity.

Forms of Creative Accounting

Different organisations employ different methods depending on their motive for engaging in creative accounting. According to Izedonmi (2006) "creative accounting could be motivated by flexibility and loopholes in accounting standard and GAAP which is evident in the accounting policy that allows different methods of depreciating an asset and stock valuation". According to Fortin (2008) creative can be done through: accounting induced operational and financial decisions, choice of accounting policies, Manipulation of accounting estimates and fraudulent transactions.

Naser(1993:45) perceives that the accounting system in Anglo-Saxon countries are particularly prone to such manipulation because of the freedom of choice it permits to choose accounting policy management perceive is more favourable to the organisation. Business analyst, accountants and shareholders who have been caught in the web of creative accounting will agree that there are weakness in the current accounts standards and GAAP which makes it easier to indulge in the evil act called creative accounting which could be in the form of: (i) not making adequate provision for doubtful or bad debt; (ii) over valuation of assets; (iii) arbitrarily changing method of depreciation; (iv) arbitrary changing method of inventory valuation; (v) capitalising expenses that should be written off within the accounting cycle or current accounting period; (vi) recording revenue to boost income in anticipation for sales; (vii) creating secret reserves in anticipation for learn year (viii) not following the proper accrual concept in order to unduly boost earnings; (ix) intentional omission of transaction(s) from financial statements; and (x) manipulation or alteration of financial records.

Motivation for Creative Accounting

The shareholders of companies are constantly interested in receiving dividend income coupled with future capital appreciation of their investment, the director wants to retain their job by reporting more earning on which their bonuses are based atimes, while trying to minimise tax liabilities payable to the relevant tax authority, and also satisfy customers, credit rating agencies, employees and trade unions. An attempt to satisfy the conflicting interesting interest of all these parties call for effective and efficient management of organisational resources lack of which make some directors to capitalise on the loopholes in the accounting standard and GAAP to indulge in financial manipulation called creative accounting.

According to Adegbaju and Umoren (2002:171) 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 package, stock options could be most profitably exercised when income is exaggerated and the stock can be sold at an inflated profit. Billings et al (2009:7) noted that compensation package tied to performance in terms of reported earnings encourage financial manipulation. Obviously, the motive of incentive tied to performance, which was to spur managers to higher levels of performance, could result in an attempt by manager to report and present financial information in a better way than it would have been if reported objectively. According to Mulford (2002) companies engage in creative accounting because of expected rewards.

The need to ensure consistency in the reported earning to satisfy the shareholders demand, expectation of dividend income and future capital appreciation, which is largely influenced by the performance of the reporting entity, is another motivation for financial manipulation. This has led to the practice such as income smoothing, this is achieved by making unnecessarily high provision for liabilities and against the assets values in good years so that these provisions can be reduced thereby improving reported profits in bad years (Amat et al, 1999). This is done to avoid raising shareholders expectation so high that the companies are unable to achieve subsequent year. This affects the financial reporting of the true picture of the organisation.

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Creative accounting could be caused by flexibility and loopholes in accounting standard and GAAP, which is evident in the accounting policy that allows different methods of depreciating an asset and stock valuation (Izedonmi, 2006). Several existing standards are open to abuse. For instance management may adopt any of the following method of stock valuation such as First in first out (FIFO) or weighted average method which has varying implications on the reported earnings. Management therefore can change to any method that suit their motives. The question is why this flexibility should continue since they have done more harm than good to the financial world.

An attempt to operate within the confine of the restrictive covenant and also presents the company less risky than it is to the investing public forces management to indulge in financial manipulations. Accounting to Sweeney (1994) "companies nearing violations of debt covenant are two to three times more likely to make income increasing accounting policy change than other companies". A high degree of financial leverage makes a company quite vulnerable to changes in earnings and also, it quite difficult to raise funds externally for financing growth (Pandey, 2001: 777). According to Shim and Siegel (1999:338) "sometimes there is credit agreement that will limit the amount of cash dividends that may be paid". This makes such companies to arrange their affairs in such a way that the financial statements show a rosier picture than it would have been.

Some important factors are ratings and analyst speculators. The company directors are aware of these (as in the case of Enron) and will want to do everything possible so that the reported profits meet or surpass analyst forecasts and at the root of this is financial manipulation. Profits falling significantly below the analysts forecasted profits might lead to panic selling of the company's shares, while reporting a profit greatly in excess of the forecast will lead to unrealistic expectations the following year. Fox (1997) reports on how accounting policies at the Microsoft are designed within the normal accounting rules to match reported earnings to profits forecast.

Corporate governance has assumed very important roles in recent times. Audit committee is a corporate governance agent that is meant to strengthen the role of external auditors and provides checks and balances to management in efficiently achieving the organisational goal. Many Commissions have zeroed in on corporate governance as the arrowhead of the success and continued prosperity of companies (Akinwolemiwa, 2005; 4). According to SEC (2003) Code of Best Practice, members of the audit committee should be able to read and understand basic financial statement with a thorough understanding of the business, its product and services, a reasonable knowledge of the risks facing the company and the essential controls the company has in place. At the root of every financial manipulation and fraudulent reporting is a non-functional audit committee (as in the case of Enron). Asein (2002:29) posited that members of the audit committee were not known to possess accounting expertise particularly as it applies to the efficacy of internal control measure.

A number of companies engage in financial manipulations by concealing their true financial picture when issuing prospectus to raise fund (in form of share capital) from the members of the public as in the case of African Petroleum Nigeria Plc. The management understated the true debt position in the prospectus issued in 2001. Some companies also engage in financial manipulation as an anti merger tactics to ward off hostile take over bidders. Many shareholders no longer trust accountants and auditors (Adegbaju and Umoren, 2002: 172). To restore business and public confidence accountants must be conversant with the real causes of creative accounting and devise strategies for addressing them.

Research hypotheses

The following research hypotheses are statistically tested to determine whether some hitherto identified causes actually/ significantly motivate management to indulge in creative accounting.

1 H_1: There is significant relationship between employees and top management compensation package tied to performance and creative accounting

2 H_1: There is significant relationship between loophole in GAAP, flexibility in accounting standard, agency rating and creative accounting.

3 H_1: There is significant relationship between shareholders demand for regular dividend and improved earnings and creative accounting.

Methodology

The study made use of primary data sourced through the use of 200 questionnaires administered on a group of respondents that covered Nigerian investors and accountants both in the academic and the practice. The survey questionnaire was divided into two parts. Part one covers the bio-statistical data while part two covers determinants of creative accounting designed on a 5- point Likert scale. The scales are very high (5 points), high (4 points), moderately high (3 points), low (2 points) and very low (1 point). One hundred and forty six questionnaires were returned representing 73% response rate. The analysis of the result was based on the valid 146 questionnaires returned by the respondents. Out of this number [146], only 125 questionnaires representing 86.5% was valid while the remaining 21 representing 14.6% was not valid. Simple frequencies table indicating percentages and chi square (X^2) statistical technique were used to analyse the data collected. The analysis was done to determine whether some hitherto so identify causes actually/ significantly motivate/impact creative accounting or they are just institution arising out tradition and researchers intuition.

Findings

The data was analysed and the results are as below:

1. 50.4% respondents are qualified with less than HND, 35.2% have HND/BSc, while 14.4% have professional qualifications in addition to their first degree. Most of the respondents are well educated and are able to appreciate the subject matter thus gave proper responses.
2. Majority of the respondents (12.8% very high, 28.8% high and 26.8% moderate) are aware about the incidence of financial manipulations. Few of the respondents (4% very low and 17.6% low) are not conversant with the incidence of financial manipulations.
3. Regarding the extent to which top management compensation package tied to performance contributes to financial manipulations, majority (84.8%) moderately or highly affirmed this.
4. Regarding the management demand for improved earnings contribute to financial manipulations, majority of the respondents rated very high (20%), high (34.4%) and moderate (36.8%).
5. Sizeable number of the respondents affirmed that shareholders' demand for improved dividend motivates the management to indulge in financial manipulations. 15.2% very high, 28.8% high, 30.4 moderately high, 23.2% low and 2.4% very low.

6. A substantial number of the respondents representing 87.2% rated as either very high, high or moderate that loopholes is GAAP contribute to financial manipulations.10.4% rated as low while only 2.4% rated as very low.
7. Majority of the respondents affirmed that flexibility in accounting standards encourage management to engage in financial manipulations.15.2% rated their level of awareness very high, 33.6% rated high, 30.4% rated moderately high, 19.2% rated low and 1.6% rated very low.
8. Majority of the respondents rated very high (8%) , high (32%) and moderate (27.2%) relating to how employees demand for improved wages contribute to financial manipulations.24% and 8.8% rated low and very low respectively.
9. Majority of the respondents rated very high (19.2%), high (24.8%) and moderate (32%) that existence of performance rating agencies and analysts speculations motivate management to indulge in financial manipulations. Low responses were 24%.

Result and Implications

As earlier stated the three hypotheses were put forward and tested using Chi square statistics. It was observed that at 1% level of significance, the Chi square (X^2) 68.35 computed is greater than the tabulated value of 13.28 at 4 degree of freedom. The implication of this result is that three null hypotheses were rejected and therefore, the alternative hypotheses were retained. The researchers therefore conclude that the hitherto identified causes such as employees and top management compensation package tied to performance, loophole in GAAP, flexibility in accounting standard, agency rating, shareholders' demand for regular dividend and improved earning actually motivate management to indulge in creative accounting. This confirmed the respondents' opinion that the following identified causes actually encourage management to engage in financial manipulations.

Summary and Conclusion

The study focused on determinants of creative accounting to determine whether the identified causes actually encourage creative accounting or that they are a product of researchers intuition that have no empirical basis. The researchers discovered that the hitherto identified factors such as employees and top management compensation package tied to performance, loophole in GAAP, flexibility in accounting standard, agency rating, and shareholders' demand for regular dividend and improved earning, actually correlate with creative accounting.

Recommendations

Based on the findings, the following are recommended to deal with the aforementioned identified causes of creative accounting:

1. Regulators and policy makers should thoroughly review GAAP and accounting standards in order to bridge the gap and loopholes;

2. The Board of Directors should adopt a pay package for both the management and employees not totally tied to performance but based on the industry standard;

3. There should be a stiff penalty by the relevant accounting bodies for any accountant engaged in financial manipulation to serve as a deterrent to others;

4. Nomination and election into the membership of audit committee should be based on integrity and relevant business experience, auditing and accounting knowledge and

5. Rating agencies should engage the services of forensic accountants and auditors who can see beyond figures presented in the financial statement.

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