The Middle East International Journal for Social Sciences (MEIJSS)
e-ISSN: 2682-8766

Vol 1, No 3 Sep (2019):95-99

THE IMPACT OF CREATIVE ACCOUNTING ON FINANCIAL STATEMENTS

Chnar Ismail Mokhlis
Department of Accounting, Lebanese French University

ABSTRACT
Creative accounting is the process through which the accounting professionals use their knowledge in order to manipulate the figures included in the financial statements. Financial statements should show realistic results of firms. Creative accounting main subject is working purposefully on adjusting those statements. Therefore, this paper is aiming to illustrate the impact of creative accounting on financial statements. In this paper, multiple definitions of creative accounting, motives behind using it and its techniques are presented in a setting that could show how they are affect the financial statements. This paper concludes that use of creative accounting tools and techniques will impact the financial statements either conducted with good intentions or bad intentions.
Keywords: Creative Accounting, Financial Statements, Techniques of Creative Accounting.

INTRODUCTION
The term “creative accounting” was first used in 1968 in the film, The Produce, by Mel Brooks (http://chaumurky.net/criterion/indept-184.html). Creative accounting is referred to also as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting. The preferred term in the USA, and consequently in most of the literature on the subject is „earnings management‟, but in Europe the preferred term is „creative accounting‟. It should be recognized that some accounting manipulation involves primarily balance sheet rather than earnings management (Karim, Fowzia and Rashid, 2011).
The reliability of the financial statements are crucial for the stakeholders of the firms in order to make appropriate decisions. Even if there are strong accounting standards (GAAP and IAS) to guide financial accounting activities, sometimes it becomes impossible to prevent the manipulative behavior of financial statement preparers, who wants to effect the decisions of the financial statement users in favor of their companies. These manipulative behaviors are often called “creative accounting” and/or “earnings management” “Creative accounting” is the more preferred term in Europe, whereas it more common to use “earnings management” in the USA (Berisha & Shala, 2014).
The financial statements are expected to inform the stakeholders on the present financial state of the organization and also determine whether or not the organization is a going concern. Financial statements are prepared to disclose the present state of a company, it reveals if the business is making profit and providing a return on shareholders’ investment (Micah and Chinwe, 2014).

Creative accounting is applied in order that the view of the company to look financially stronger or weaker depending on the aspirations of management. Using creative accounting practices, managements can alter impressions about their firms' business performance. Periods of crisis represent in fact tests for companies and managers who are tempted to resort to ingenious methods, often questionable, in order to improve the presentation of financial statements. The 1990s were characterized by mass use of manipulative practices in accounting more prestigious American firms, for example as Enron, WorldCom, AOL, which was renuan like a castle of sand within a very short period. Their involvement in abuses accounting system has caused more damage, which extend beyond the financial costs. Speaking glancing different reports written after the failure of these companies, almost all the actors involved in rigging have tried to justified with the excuse that the introduction of an accounting "creative" cannot be called fraud, while manipulation were legal frameworks that GAAP has set. Even if there exist strong accounting standards (GAAP and IAS) to guide financial accounting activities, sometimes it becomes impossible to prevent the manipulative behavior of financial statement preparers, who wants to effect the decisions of the financial statement users in favor of their companies. Most manipulations have passed the limits of the use of space to let GAAP, passing by really creative in rogue, using illegal practices, totally contrary to the rules, distorting, add or remove many of the factual data, and this order to reflect their situation in a way that will help them to achieve their goals. The difference between creative accounting and fraud is that creative accounting operates within the regulatory framework, while fraud involves a violation of law or breach of regulatory framework (Berisha & Shala, 2014).

STATEMENT OF PROBLEM

It is crucial that financial statements show exact financial position of firms. These statements are used as decision making basis by the stakeholders. Sometimes, accountants are using certain techniques, which are called creative accounting, in order to influence accounting results in the financial statements. Thus, this paper is aiming at investigating the impact of creative accounting on financial statements of firms (Akapanuko & Umoren, 2018).

RESEARCH QUESTIONS

This paper strives to answer the following questions:
What is creative accounting and what are its motives?
What are the techniques of creative accounting?
How creative accounting impacts the financial statements?

RESEARCH OBJECTIVE

Financial statements should show realistic results of firms. Creative accounting main subject is working purposefully on adjusting those statements. Therefore, this paper is aiming to illustrate the impact of creative accounting on financial statements.

LITERATURE REVIEW

The concept of creative accounting is 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 (Berisha & Shala, 2014)

According to Sen and Inanga (2008), cosmetic accounting is not totally objectionable. However, when unethical elements and the motive are wrong, a negative intrusion is the outcome of the accounting details which become unreliable. Jameson (1985) noted that cosmetic accounting is aimed at manipulation, deceit and misrepresentation of financial statements. This, therefore, has a rippling effect on the decision making of investors. Naser (1993) also noted that auditors in United Kingdom and Spain have different views on cosmetic accounting. Thus, creative or cosmetic accounting is viewed differently (Fagbemi, Olaoye, 2014).

Creative accounting uses a set of procedures which have as their objective the change in the level of the result, be in order to optimize his, be in order to minimize its financial statements. The procedures used are based on accounting regulations prerequisites, that use, however, of the shortcomings of the accounting rules and of the mechanisms that accounts put them at the disposal of the professionals to intervene on the information that you submit financial statements (Mârza, Mărcuță,& Mărcuță, 2017).

Creative accounting are 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 (Asuquo, 2011). Also it has been defined as 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).

Practice of earning management has positive and negative sides. The positive side perceives that the practice is a legitimate product, while the negative side deems it as immoral and unethical attitudes. Those who opine in a positive side argue that earnings management is a professional judgment on preparing financial statements for external parties that is conducted by applying accounting policies. As long as the policy is in accordance with accounting standards, then the practice is considered as a legal practice and in average is not injurious (Jiraporn et.al 2006).

On a negative side, some argue that earning management is a practice of increasing or decreasing profit for the sake of management interests (DuCharme et. al. 2004). It is done, because management is under a pressure of others. Earning management is not a good practice, because it may mislead stakeholders in interpreting the economic performance of a company to a mistaken direction. Consequently, they may make wrong economic decisions. It is considered as an act of misleading and deceiving stakeholders and therefore it is an illegal, immoral, and unethical practice (Grasso et.al, 2009).

Healy & Wahlen (1999) and DuCharme et. al. (2004), in a neutral position, explicate technically the practice of earning management. For them, earning management is a practice of income increasing by shifting future income into current income or shifting current costs into future costs, so that earnings in the current period is reported higher than it should be or otherwise.

There are many factors regarded as the reasons of applying creative accounting or earning management techniques. One of the most cited incentive in the literature is the expected increase in the stock prices. It can be concluded easily that the incentives of creative accounting is the following advantages: presenting the best possible earnings picture so as to maximize the price at which the issue is sold; causing earnings to remain between the minimum and maximum earnings level so as to maximize incentive compensation; minimizing the political costs of size and/or industry membership by avoiding what might be considered excessive profit levels; avoiding the potential adverse effects of a covenants violation (for example, an interest rate increase, a demand for security or immediate repayment); avoiding an improper market response to earnings being temporarily off trend; reducing earnings volatility so that a valuation penalty, associated with a perceived higher level of risk, is not assessed; taking large write-offs immediately upon the arrival of new management, relieving future results of the charges and permitting blame to be assigned to outgoing management; reserving any overstated portion of the accruals in order to achieve earnings goals in later periods (Beidlamen, 1973).

Also, 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 (Asuquo, 2011)

Techniques of Creative Accounting

Management may use different types of creative accounting techniques to manipulate the result represented in the financial statements which complying with all applied accounting standards and other regulations. There are various methods used for creative accounting which can fall into four categories: Different accounting policies, abuse of judgment, artificial transactions (substance over form), and the timing of genuine transactions. The techniques that management used for creative accounting are: Window dressing, off balance sheet finance, changes in accounting policies, profit smoothing, capitalizing expenses, contingent liabilities, changes in depreciation policy, etc. (Ismael, 2017).

There are also many other techniques that has been used by different firms all over the world. For the sake of lack of time and space of this paper we clarify in brief few techniques of creative accounting.

For example, window dressing involves the adjustment of financial statements of a company to achieve the maximum effect on the financial position at a particular date. Also off balance sheet financing is a situation where total debts of a company increases but the increased borrowing is not reflected in the financial statements of the company (Asuquo, 2011). And, capitalizing expenses refers to the treatment of development expenses, the fund, formation expenses, revaluation, depreciation policy and depreciation adjustments, capitalization of post-commissioning expenses and interest (Mârza, Mărcuță,& Mărcuță, 2017).

Impact of Creative Accounting on Financial Statements

Accounting creativity is euphemism and contributes 90% to the unfair reporting of firms operations. The creativity in those practices is motivated by greed and intended to deceive the public, potential investors and shareholders and increases the rate of enterprise failures at a decreasing rate. However, the study revealed that the many regulations without adequate checks, punishments and rewards complement creative accounting in providing the foundation for make-believe, cosmetic and unfair reporting (Akapanuko & Umoren, 2018).

Furthermore, creative accounting promotes and sustains company's image, and to select information so that the data offered should maintain the interest that they have in mind. The fact is that the managers under financial pressure are looking for solutions without thinking of ethical issue at hand. In other words, a half-truth and lying could be likely considered as fraud. The presence of options based on freedom of choice and appreciation enables management enterprise, according to its interests, to reverse reasons or translate legal, economic and financial innovations for problems that cannot be yet solved by regulations, which leads to creative accounting and subjectivism resulting in the shaping of results and financial statement contents (Marlina & Corina, 2012).

Conclusion

Based on all the above, we can say that creative accounting basically works on showing financial results to the stakeholders in a favored form by management or main shareholders. This act most of the time, needs implicit alterations in the financial data presented in the financial statements. Thus creative accounting has great impact on the financial statements and the ways that they are prepared and presented.

References

Akpanuko, Essien & Ntiedo Umoren, 2018, The influence of creative accounting on the credibility of accounting reports, Journal of Financial Reporting and Accounting, Vol. 16 No. 2, pp. 292-310.

Beidlamen, C.R, 1973, Income smoothing: the role of management, The Accounting Review, pp 658-667.

Berisha, Vlora & Shala, Albulena, 2014, EFFECT OF CREATIVE ACCOUNTING ON THE COMPANY, 8th International Scientific Conference on Economic and Social Development and 4th Eastern European ESD Conference: Building Resilient Economy, Zagreb, Croatia.

Bernstein, Leopold A, 1987, The concept of materiality Accounting review, CAMA (1990). Synoptic Guide. Lawlord Publication Aubja: 2006.

Dr. Asuquo, Akabom Ita, 2011, THE IMPACT OF CREATIVE ACCOUNTING AND EARNINGS MANAGEMENT ON MODERN FINANCIAL REPORTING, The Nigerian Academic Forum Volume 20 No. 1 April, 2011.

DuCharme, L.L., Malatesta, P.H., & Sefcik, S.E., 2004, Earnings management, stock issues and shareholder lawsuits, Journal of Financial Economics vol 71, pp 27-49.

Fagbemi, Temitope Olamide, Olaoye, Joshua Adeyemi, 2014, Cosmetic Accounting: A Review of Literature and Perception of Accountants in Nigeria, Journal of Poverty, Investment and Development, International Journal Vol.3, pp 85-90.

Grasso, Lawrence, P., Patricia, A.T., & Richard, A.W., 2009, The ethics of earnings management: perceptions after Sarbanes-Oxley. http://findarticles.com/p/ articles. Acces Nov 23, 2019.

Heally, P.M., & Wahlen, J.M., 1998, A Review of The Earnings management literature and its implication for standard setting, Accounting Horizon 12, No. 4, pp 365-383.

Ismael, Ahmed Yousif Adam, 2017, The Impact of Creative Accounting Techniques on the Reliability of

Financial Reporting with Particular Reference to Saudi Auditors and Academics, International Journal of Economics and Financial Issues | Vol 7, Issue 2, pp 283-291.
Jameson, M, 1985, Practical Guide to Creative Accounting, London: Century Business.
Jiraporn, P., Miller, A.G., Yoon, S.S., and Young, S.K., 2008, Is earning management opportunistic or beneficial? An agency theory perspective, International Review of Financial Analysis vol 17, pp 622–634.
Karim, Fowzia & Rashid, 2011, Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives, World Journal of Social Sciences Vol. 1. No. 3. July 2011. Pp. 1-15
Marilena, Zuca & Corina, Ioanas, 2012, Embellishment of financial statements through creative accounting policies and options, Procedia - Social and Behavioral Sciences, vol 62, pp 347 – 351.
MÂRZA, Bogdan, MĂRCUȚĂ, Alina, MĂRCUȚĂ Liviu, 2017, THE IMPACT OF CREATIVE ACCOUNTING ON THE PREPARING AND PRESENTATION OF FINANCIAL STATEMENTS, Revista Economică pp 129-136 (2017).
Micah, Leyira Christian & Chinwe, Okeoma Eunice, 2014, The Impact of Creative Accounting on Organizational Effectiveness: A Study of Manufacturing Firms in Nigeria.
Naser, K. (1993), Creative Financial Accounting: Its Nature and Use, Hemel Hempstead: Prentice Hall
Sen, D. K. & Inanga, E. L. (2008), 'Creative Accounting in Bangladesh and Global Perspectives, Partners' Conference Program Book, Maastricht School of Management, the Netherlands pp 75-87.