The Contribution of Creative Accounting on Economic Development

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Abstract

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. This study presented the frame work, short falls and motives for creative accounting in economic development. Descriptive analysis and inferences from existing literature on the effect of creative accounting was used to discuss the negative effects of creative accounting on global development. It was suggested that since the practice of creative accounting is completely deceptive and fraudulent the implementation of measures such as reducing the scope for choice of accounting methods by reducing the number of permitted accounting methods, thus specifying circumstances in which each method should be used. Also, the abuse of judgment can be curbed by drafting rules that minimize the use of judgment and prescribe consistency so that if a company chooses an accounting policy that suits it in one year, it will be forced to use the same method in future circumstances where the result may be less favourable.

Key words: Transactions, manipulation, judgement, conflict, motives, literature, methods

1 INTRODUCTION

The accounting profession has worked diligently through the years to develop the most rigorous system of accounting procedure and principles in the world [1]. However, publicly traded companies have a great deal of discretion in choosing accounting principles and in making estimates that impact on their reported financial results. Under Generally Accepted Accounting Principle (GAAP) two fundamental principles of accounting known as Conservatism and Objectivity control the amount of discretion that company has in preparing financial statement. These two guiding principles are sometimes stretched to the limit or even ignored. When conservatism or objectivity is impaired, creative accounting is compromised. A firm is supposed to employ procedures that are objective and conservative but in practice, management may have many competing motivation that drive their choice of accounting policies which influence their periodic estimates. Creative accounting is a term used to refer to the aggressive use of choices available under accounting rules, to present the most fattening view of a company possibly in its financial statement. It involves the pushing of accounting principles to the limits of their flexibility or even beyond so as to improve their annual statements. They seek loopholes in financial reporting standard which they can exploit to adjust the numbers as much as is practicable to achieve their desired aim or satisfy their financial projections. Many companies manipulate accounting numbers in order to facilitate the financial reporting goals established by management. They could misstate their true profitability by adopting an extremely aggressive revenue recognitions policy that, while not in technical violation of SAS, has the effect of substantially overstating the company's true profitability. According to [1], much of the process of accounting has to do with allocation of both revenue and expenses to specific accounting periods, and this result in rules which leave some degree of discretion and call for subjective judgements. Accounting allocations are always open to debate at times creating hidden reserves when profits are good, but also releasing these when profits are down. Thus, accountants use accounting choices to 'manage' their published results. Thus, creative accounting is the purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain. He stressed that that effect of accounting manipulations can be disastrous leading to a total loss of corporate image and executive integrity. Creative accounting is at the root of a number of accounting scandals in the world such as Enron and World Com in the USA, Cadbury Nigeria Plc, Unilever, African Petroleum and Afribank in Nigeria. There has been multiplicity of public limited liability companies as well as a large increase in the number of investors. Regular auditing of such corporate financial reports has been mandatory. Modern organized sophisticated corporate frauds have been on the increase almost on daily bases. Several instances of corporate scandals and failure in recent past and the failure of statutory audit to prevent and reduce misappropriation of corporate fund has put pressure on the professional accountant and legal practitioner to find a better way of exposing fraud in business world. Creative accounting has been the cancer behind this new face of crime in the land involving the cooking or roasting of financial statements and conventional audit has been inadequate in handling it. Fraud was described in the twilight of the 20th century as the "crime of the future". The accounting profession seems not to have realized the stigma this is causing to the profession. If there are carefully articulated and professionally executed control schemes of an accounting, auditing and investigative nature would it not have put a stop to these irregular financial practices which has fostered unexpected strains and hiccups in the economy globally? Shouldn't the accounting profession accept more responsibilities and get the possibilities of arresting this cancerous situation in the economy? Everyone is affected one way or the other by this dilemma, is it not high time the accountants sought for a financial messiah? These are our worries.

2 MATERIAL AND METHODOLOGY

Descriptive analysis and inferences from existing literature on the effect of creative accounting to the economy was used to add colour to the present study.

2.1 Conceptual Framework

According to [2], the term creative accounting was first used in 1968 in the United State in the film 'the producers' by Mel Brooks. In different literatures, creative accounting has been called different names such as earning management; innovation accounting; aggressive accounting; cosmetic accounting; financial accounting ; earning smoothing; income smoothing; Earning management. In their own contribution [3], defined creative accounting as the manipulation of financial numbers, usually within the letter the law and accounting standard but very much against their spirits and certainly not providing the 'true and fair view' of a company accounts are suppose to. [4], reported that creative accounting is a process whereby accountant use their knowledge of accounting rules to manipulate the figures reported in the accounts of business. [5], posited that creative accounting are euphemisms referring to accounting practices but certainly deviate from the spirit of those rules. [6], argued that creative accounting occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economy performance of a company or to influence contractual outcome that depend on reported accounting numbers. They further explained that creative accounting usually involves the artificial increase or decrease of revenue, profit, or earning per share through aggressive accounting tactics. It is a form of fraud and differs from reporting error. [7], writing from the perspective of a business journalist observed that 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. In another concept [8] reporting from the accounting perspective 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 of the accounting profession have come to be known as creative accounting.

2.2 Short falls of Creative Accounting

1) Accounting rules sometimes allow a company to choose between different accounting methods. Example a policy of either writing off development expenditure as it occurs or amortizing it over the life of the related project. A company can therefore choose the accounting policy that gives their preferred image.

2) There are certain entries in the accounts that involve an unavoidable degree of estimation judgment and prediction e.g. Estimate of an asset's useful life made in order to calculate depreciation. The management then is given the opportunity to err on the side of caution or optimism in making estimates as this estimates ate normally made inside the business.

Earlier studies according to [9], has also found that management often focuses on the following four types of Creative Accounting tactics or activities: decreasing discretionary Research and Development (R & D) expense; decreasing discretionary advertising expenses; timing the sale of fixed assets to report gains; overproduction reflection and intention to cut prices or extend more lenient credit terms to boost sales and/or to decrease Cost of Goods Sold (GOGS). [10] reported in his study that a number of Chief Executive Officers interviewed admitted to a number of activities (which are creating accounting activities), these activities includes; delaying or cutting the travel budgets and maintenance expenses ; postponing or eliminating capital investment (to avoid depreciation charges) and asset securitizations and managing the funding of pension plans.

2.3 Motives for Creative Accounting

Creative accounting is intended to mislead users into accepting the picture that preparers of accounts would prefer to see reported. Thus, studies have shown that creative accounting does exist and it occurs for various reasons. According to [6], the reason for creative accounting include influencing capital market expectations and valuation, to increase management's compensation, to avoid violating contracts written in terms of accounting numbers and to reduce regulatory costs. In shedding light to these reasons, creative accounting, they explained that the use of accounting information by financial analyst and investors to value stocks has created an incentive for managers to manipulate earnings to influence the short-term performance of the stock. The evidence gathered by researchers show that some firms manage earnings for stock market reasons. The frequency of this occurrence has not yet been determined. Some studies show that compensation and lending contracts give an incentive for firms to manage earnings to increases bonuses, improve job security and mitigate potential violation of debt covenants. Creative Accounting, due to regulatory motivation, is another area where researchers have began to discover evidence. Studies suggest that regulatory considerations can induce firms to mange earnings. There is very little evidence, though, on the frequency of this behaviour and the effect on regulators investors [6]. [11], stated that the key motives for creative accounting is to hide a particular bad year for a company to force an exceptionally good year or continue the pressure to always be the best, smooth-out results to give impression of stability or sustained improvement and hide large profit by monopolies under anti-trust threat, and to boost assets to avoid take over. In his own contribution [1] noted that the early warning signs of Creative Accounting include; Cash flows that are not correlated with earnings; Debtors balances that are not correlated with revenue; Allowances for bad debts that have no correlation with debtors balances; Reserves that are not correlated with balance sheet items; Acquisitions with apparently no business purpose; Earnings that consistently and precisely meet the expectations of analysis.

3 INFERENTIAL ANALYSIS

From the reasoning of most Chief executives involved in creative accounting, one can see that it is completely deceptive and fraudulent. Creative accounting is at the root of a number of accounting scandals in Nigeria at present and in the world at large. These include the case of Enron and World com in the USA, Caldbury Nigeria Plc, Unilever, African Petroleum and Afrikbank in Nigeria. Also, the scenario of the recent five commercial deposit bank scandal (Intercontinental, Union Bank, Oceanic bank, Finbank and Afribank) in Nigeria where these banks were loaded down with non-performing loans and their balance sheets been creatively "cooked" and even "roasted" to give a false picture of prosperity and buoyancy. This affected the capital market which was characterized by rush between 2004 and 2008 for initial public offers (IPO). Evidence was later given that these offers were packaged to achieve favourable price and market conditions for the financial institutions and their management. In addition, it was observed that out of a total loan portfolio of N2.8 trillion, the five banks had aggregate non-performing loans of N1.143 trillion while the margin loan they granted for investment in the capital market stood at N456.28 billion. Exposure to oil and gas sector stood at N487.02 billion with the crash in oil and capital market prices, the banks immediately encountered capital-liquidity problems. At the climax of event, Central Bank of Nigeria had to inject additional N420 billion of funds to bailout the banks. Interestingly, recall that these were non-performing loans covered up creatively in the balance sheet of these banks, hence, if not for the adverse audit findings reported by joint inspectors from the Central Bank of Nigeria and Nigerian Deposit Insurance Corporation (NDIC) the creative acts would not have been exposed. In financial reporting which lend support to [12], who revealed that accounting based principles and processes should be streamlined in order to reduce diversities of human judgements on accounting issues. They recommended that strict measures should be adopted against all forms of creative accounting and accountants in Nigeria banks should uphold high ethical standards and maintain integrity in all their professional confidence, by stopping the fraudulent practices of creative accounting. [13], pointed to the neglect and disregards of the principles of conservation and objectively in respect of revenue recognition necessitating the adoption of aggressive revenue recognition policy in the name of creative accounting to mislead the capital market corporate governance and responsibilities has been sacrificed at the altar of nepotism and conception especially in the present business environment in Nigeria.

4 CONCLUSION

As observed that creative accounting as discussed in this present study is completely deceptive and fraudulent we recommend that the scope for choice of accounting methods be reduced by reducing the number of permitted accounting methods, thus specifying circumstances in which each method should be used. Also, we believe that the abuse of judgment can be curbed by drafting rules that minimize the use of judgment and prescribe consistency so that if a company chooses an accounting policy that suits it in one year, it will be forced to use the same method in future circumstances where the result may be less favourable. Auditors should have a part to play in identifying and reporting dishonest estimates. Auditors should be given the responsibility of defecting and reporting all instances of creating accounting.

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