ROMA TRE
UNIVERSITÀ DEGLI STUDI

ACCOUNTING STANDARDS' FLEXIBILITY AND CREATIVE ACCOUNTING

Simona Arduini

ISSN 2611-9633
Working Papers (Dipartimento di Economia Aziendale)
[online]

Working Paper Numero 6, 2018
Collana del Dipartimento di Economia Aziendale

I Working Paper del Dipartimento di Economia Aziendale svolgono la funzione di divulgare tempestivamente, in forma definitiva o provvisoria, i risultati di ricerche scientifiche originali.
La loro pubblicazione è soggetta all'approvazione del Comitato Scientifico.
Per ciascuna pubblicazione vengono soddisfatti gli obblighi previsti dall'art. l del D.L.L. 31 agosto 1945 n. 660 e successive modifiche.
Copie della presente pubblicazione possono essere richieste alla Redazione.
Esemplare fuori commercio ai sensi della Legge 14 aprile 2004 n. 106.

REDAZIONE
Dipartimento di Economia Aziendale
Università degli Studi Roma Tre
Via Silvio D'Amico, 77
00145 Roma – Italia
Email:
ricerca.economiaaziendale@uniroma3.it

Abstract

In the last two decades, many economists have stressed the role of accounting standards' flexibility in proliferating the phenomenon of financial engineering, creative accounting and, as often referred to, "cooking the books". Many other scholars have tried to explain financial scandals caused by excessive earnings management with the social and ethical value on which the accounting system is founded in the different countries of the world. In this paper, we argue that financial flexibility is not an obstacle in achieving a financial reporting disclosure that is able to be fair and true if the reporting process is in line with ethical principles, too. We also believe that even if the accounting rules flexibility may, in some cases, affect the fairness of financial reporting, the underhand risks of a too rigid accounting system are also considerable. We offer, at last, an interpretation of the relationship between flexibility and accounting policies based on the Italian financial accounting traditional theory.

Keywords: Accounting policies – Creative accounting – Earnings smoothing – Ethical disclosure – Financial reporting objectives – Manipulating financial results – Subjectivity application of accounting rules.

J.E.L. classification: M14, M21, M41.

email address: simona.arduini@uniroma3.it

1. What is creative accounting? A literature review

The profile of creative accounting can be outlined by the exam of its features.

The first is “the use of flexibility provided within the accounting principles or accounting standards to manage recognition, measurement or presentation of different accounting facts to serve the purpose of those who prepare the accounts rather than of who are likely to use these accounts” (D. Kumar Khatri, 2015, p. 1). This kind of use of flexibility is red by many authors as morally reprehensible from an ethical perspective, because the information is not fair to all stakeholders and the manipulation involves an “unjust exercise of power” (C. Gowthorpe, O. Amat, 2005, p. 63) of some users relative to others. The same authors consider also another kind of manipulation, called the “macroeconomic” one: it involves “the lobbying of regulators to persuade them to produce regulation that is more favorable to the interests of preparers” (p. 55).

Similar to flexibility, but stronger, is the use of subjectivity – if permitted by regulators – in the interpretation of accounting rules (I. Della Torre, 2008). This practice is also called “aggressive accounting”, because the financial information, even if it’s compliant with the law or the accounting standards, does not reflect the real situation of the company. The role of managers’ judgement in drawing up accounting and influencing outcomes has been pointed up by P.M. Healey, J.M. Wahlen (1999), who have detected how earnings management can take place if standard setters allow managers exercise much judgement in reporting.

Creative accounting, therefore, is a very broad subject. J. Blake and O.A. Salas (2001) identify four different situations that can make creative accounting emerge:

- the possibility for a company to choose between different accounting methods or policies;

- the existence of “an unavoidable degree of estimation, judgement, and prediction” (p. 157);
- the profit’s shift between accounting periods, through artificial transactions;
- the profit’s shift between accounting period, through genuine and permitted transactions.

J. Blake, R. Bond, O. Amat, E. Oliveras (2000), in addition to the mentioned ways in which manipulation may arise, include the bias in the making of accounting valuations, too.

The definition of creative accounting is so broad that while some authors include fraudulent financial reporting in the use of creativity in reporting (C.W. Mulford, E.E. Cominsky, 2002), some others, like the U.K. Chartered Institute of Management Accountants, propose a much narrower definition of such a manipulation, founded on the goal to give a favourable impression of the company’s results.

M. Jones (2011) believes that creative accounting doesn’t include fraud; he qualifies it by the use of flexibility to manage the measurement and presentation of accounts in a way that benefits the accounts’ preparers instead of the users. A similar approach is adopted by M. Billings (2011, p. 1185) who states that “The difference between creative accounting and fraud is analogous to the distinction usually made between tax avoidance and tax evasion. In both case the former is legal and the latter not”. This meaning of creative accounting is very similar to the definition of “window dressing”, a practice in which “accounts still comply with the letter of the law and accounting standards, although not necessarily their spirit” (G. Breton, R.J. Taffler, 1995, p. 82; K.H.M. Naser, 1993, chapter 12).

Many studies are focused on motivations for creative accounting; other emphasize the negative, as well as positive, aspects of accounting manipulation.

With reference to motivations, many authors, like A. K. Malhotra (2013) and R. Bakare (2016), identify various reasons causing creativity in reporting: executive compensation linked to income measurement; need to reduce the profits' variability; tax levies based on income; advisability to attend to investors' (or others stakeholders) expectations; matching reported earnings to profit forecasts; existence of constraint or obligations based on the reported amounts of earnings.

Relative to the consequences of accounts' "make-up", it is possible to examine the topic from two different points of view: "one positive in which creativity has an innovative role bringing added value to the accounting science, and other, negative that uses «unorthodox» practices to present in a favourable position something that does not exist" (A.K. Malhotra, 2013, p. 16). Smoothing interventions, for example, are a way to obtain relative absence of income variability – that is one measure of earnings high quality K. Schipper, L. Vincent, 2003) – and can be achieved by creative accounting. But creative accounting can also cause failures and scandals, as a large literature has highlighted in the last decade (C.C. Chang, J. Duke, S.J. Hsieh, 2011; M. Agostini, G. Favero, 2017; M. Omurgonulsen, U. Omurgolunsen, 2009).

According to some scholars, it's the importance of ethics in company's accounting policies that determines the difference between constructive and damaging creative accounting's practices (F. Tassadaq, Q.A. Malik, 2015). In addition to ethical values at the microeconomic level, other researchers, following Gray's model (S.J. Gray, 1988; S.J. Gray, H.M. Vint, 1995) also assign relevance to social values that underlie national and international accounting models.

The nature (positive/constructive or negative/deceptive) of creative accounting is therefore affected by the ethical profile of both companies and national or international accounting frameworks.

2. Creative accounting versus accounting policies

Considering the literature described above, it’s possible to state that:

- creative accounting doesn’t involve necessarily frauds, deceits or falsities; it’s possible to be “creative” in filling companies accounts without being outlaw;
- creative accounting may be the results of a choice between permitted alternative accounting policies or a natural consequence of financial reporting flexibility or the effect of the assignment of a great degree of discretion in preparing financial reporting (J.K. Niyama, A.M. Gomes Rodrigues, 2015).

In any case, creative accounting consists of manipulation of financial results; to understand the consequences of this manipulation, it’s important to analyze what is exactly the process of “transformation” of financial accounting figures and to outline the edge of the positive creative accounting.

To manipulate the items of annual accounts means to underrate or to overstate the value of one or more items, often to support a particular group of stakeholder.

The terms “underrate” and “overstate” could denote a misleading view of the company’s reality if referred to an item that has an objective value. On the contrary, if there are many possible values that the item can have, it is much more difficult to identify a fallacious esteem.

It being understood that we want to refer only to manipulations that are not illegal, in our opinion, it is very important to distinguish two variables that affect manipulations:

- the typology and the numbers of stakeholders that take advantage from the manipulation;
- the quantitative weight of the item manipulated relative to firm’s other revenues/costs, or assets/liabilities.

It is evident, in fact, that if a company accounts for a transaction in such a way that it underestimates one year's earnings and overestimates the next years' earnings, but the transaction has not a significant impact on average annual earnings, this fact doesn't assume the form of creative accounting, because there isn't a real manipulation: it's simply an accounting policy.

In addition to account manipulation, creative accounting is featured by the goal to take advantage to some stakeholders at the expense to some others. A manipulation that favours, for example, investors, because it tries to smooth earnings over time, but does not disadvantage tax authorities, employees, creditors, and so on, can't be the cause of creative accounting.

We believe, therefore, that there are three levels of manipulations:

- manipulations that define crimes or frauds, because they infringe a law;
- manipulations that cause creative accounting, when they are not outlaw, but they damage a stakeholder and have a significant impact on the average level of earnings;
- other manipulations, that can be define as simply accounting policies.

Even if all the three way to manipulate accounts, listed above, are characterized by a conscious distortion of reality (A.K. Malhotra, 2013), only the first and the second are able to produce a damage to some stakeholder in order to advantage others.

As the international literature, in the last two decades, has been focused on creative accounting but has much less addressed the topic of accounting policies, in the next page we will mention the Italian traditional theory on accounting policies, to understand which links exist between the two topics.

Our traditional Italian culture on financial and economic matters has made us understand that there is a dichotomy between the financial reporting's flexibility and the willingness to be compliant to reporting standards and laws.

In the Italian financial accounting traditional theory, Pietro Onida (P. Onida, 1951, p. 21), teaches that annual profit is an “abstract quantity” i.e. it isn’t an indisputable quantity, because the profit value depends on the value of revenues and costs and they, in turn, vary because of the accrual accounting method. In fact, when an accountant applies the accrual method to estimate annual profit, there is an unavoidable degree of estimation, judgement, subjectivity and prediction. However, the choice of recognizing and reporting a revenue or a cost depends on the goal assigned to financial reporting.

Onida thinks also that financial reporting may have many goals: for every purpose it is possible to identify a set of recognition criteria and measurement concepts for assets and liabilities and, then, for revenues and expenses (P. Onida, 1951, pp. 109-110); all valuation methods may be theoretically correct, if they are consistent with the goal of the financial statement framework.

Many theories have been developed in the last hundred years on the goals of financial reporting: some have nowadays only a theoretical and historical relevance; some others (and particularly, those called “ALFA goal” and “BETA goal”) have been used in practice to inspiring accountants and auditors work (G. Zanda, 2007, pp. 46-70). “ALFA goal” considers profit as an indication of the trend of events that affect the firm during a reporting period: profits are then volatile and have dramatic rises and falls over the time. “BETA theory”, on the contrary, argues that annual accounts have to be an indication of firm profitability: income has to be smoothed over time and trend in profit must be steady.

Anyway, accountants have first to outline the goals of external reporting (or the reasons for which the annual accounts are drawn up) and, then, to fix the method to evaluate assets and liabilities. This practice permits to achieve a high level of flexibility, but makes impossible to standardize and to compare accounts of different enterprises.

Conversely, many countries' laws on financial reporting (such as Italian law for not public companies' financial reporting) and the most widespread accounting standards have followed another way: they have chosen a set of accounting principles, suitable for some of the goals, but they have not clarified which goal accountants have to achieve. In this way, the annual accounts are less flexible, but they can be easily compared.

Many Italian economists has supported the idea that these two approaches were not really divergent (P. Capaldo, 1998, pp. 51-52) and that it's also possible to choose a "via intermedia" (an intermediate way), that means to identify some relevant earnings models (some paradigmatic models for profit) and to adapt these models to practical or theoretical situations.

However, in the last thirty years, a fracture between theory on one side and laws/accounting standards on the other side was dramatically evident. Accountants asked to reach flexibility by fixing a set of goals to assign to the annual accounts and by leaving freedom to choose principles that could reach these goals; laws detected hazy goals but identified compelling accounting principles. Among these principles, for example, for long time (at least about in pre-IFRS period) prudence had in Italy a deep-rooted role, as laws wanted to favour firms' creditors.

In the international environment the quest for flexibility has accompanied the development of standardized accounting standards and while the rules were becoming gradually more contingent, some phenomenon, such as "creative accounting" and "financial engineering", began to be studied in theory and to be applied in practice, to the point of giving rise to well-known financial scandals.

In fact, even if the first studies on "creative accounting" are, indeed, much older than two/three decades (in the U.K., the term "creative accounting" was thought up in the second half of the Eighties and in the U.S.A., in the Nineties) the topic became really well known in all industrialized countries in the second part of Nineties. In more recent years, many scholars study the phenomenon of “earnings quality”, that is, in our opinion, an evolution, in a positive way, of the studies on creative accounting, as a tool to prevent negative accounts’ manipulations.

3. Conclusions and implications for future research

The current study contributes to emphasize the literature debate on the consequences of creative accounting and on the differences between deceptive accounts’ manipulations and accounting policies.

In this paper, we argue that creativity in accounting is not always reprehensible, because, in some cases, it’s only the result of using accountants’ personal judgement on matters on which law is flexible.

It’s therefore important to distinguish, on one hand, accounts’ manipulations that conduct to falsities and frauds and negative creative accounting, that are always to be convicted, and, on the other hand, positive creative accounting and/or accounting policies; the latter, without damaging any stakeholders, can be useful to improve the quality of earnings or to implement information that is not expressly requested by rules.

We believe that flexibility is not the main cause of “creativity”, but only a way to make accounting more “creative”. Flexibility, for example, allows managers to account also for information that are not requested by laws, or to record non-financial information, like the social or the environmental impact of firm’s activities or their sustainability. In this sense, flexibility is not deceptive, because it can lead to a more complete annual reporting (J. Dumay, C. Bernardi, J. Guthrie, P. Demartini, 2016) and improve ethical behavior in accounting.

There are, moreover, assets and liabilities whose valuation is unavoidably subjective and the flexibility is a tool to permit to reflex the real substance of the item.

To make flexibility work and, at the same time, to avoid financial scandals, the principle of substance over form should never be understated and ethical value must never be neglected, both on the companies' level and on the countries' accounting framework level. Even if the development and the spread of creative accounting are not depending on the accounting model adopted in a single country (J. Blake, O.A. Salas, 2011), the ethical values that distinguish a culture or a society may affect the practice of account manipulation.

The current research also presents numerous limitations, such as the lack of empirical data on the frequency of accounting policies and creative accounting practices, or the absence of statistical surveys on the number of companies in which creativity in accounting has determined frauds or failures. We are confident this study represents a first step to develop studies on creative accounting applied to the Italian market and, over all, to enhance the role of ethics in accounting.

Conclusively, we underline that flexibility in accounting principles should not be interpreted as an obstacle to a fair reporting, but as an opportunity to reflect a best view of a company's situation.

Negative creative accounting has not its roots in flexibility, but in the lack of ethics; it's the latter that improves the deceptive creative practices and not the account creativity to lead to unethical behavior.

Managers, therefore, have to use the flexibility allowed by accounting standards to make the financial reporting a realistic photograph of the company's situation, useful for all stakeholders.

References

M. AGOSTINI, G. FAVERO (2017), *Accounting fraud, business failure and creative auditing: A microanalysis of the strange case of the Sunbeam Corporation*, in *Accounting History*, vol. 22, n. 4.

R. BAKARE (2016), *Creative accounting: a white knight or a poison pill?*, in *International Journal of Sales, Retailing and Marketing*, vol. 5, n. 4.

M. BILLINGS (2011), *Review of Creative accounting, fraud and international accounting scandals*, in *Business History*.

J. BLAKE, O.A. SALAS (2001), *Corporate Governance and Creative Accounting: A Comparison between Spain and the UK*, in S. MCLEAY, A. RICCABONI (EDITORS), *Contemporary Issues in Accounting Regulation, Springer*, NY.

J. BLAKE, R. BOND, O. AMAT, E. OLIVERAS (2000), *The ethics of creative accounting – some Spanish evidence*, in *Business Ethics: a European Review*, vol. 9, n. 3, July.

G. BRETON, R.J. TAFFLER, *Creative Accounting and Investment Analyst Response*, in *Accounting and Business Research*, vol. 25, n. 98.

P. CAPALDO (1998), *Reddito, capitale e bilancio di esercizio. Una introduzione*, Giuffrè, Milano.

C.C. CHANG, J. DUKE, S.J. HSIEH (2011), *A Loophole in Financial Accounting: A Detailed Analysis Of Repo 105*, in *The Journal of Applied Business Research*, September-October.

I. DE LA TORRE (2008), *Creative Accounting Exposed*, Palgrave Macmillan, London.

J. DUMAY, C. BERNARDI, J. GUTHRIE, P. DEMARTINI (2016), *Integrated reporting: A structured literature review*, in *Accounting Forum*, vol. 40, n. 3.

C. GOWTHORPE, O. AMAT (2005), *Creative Accounting: Some Ethical Issues of Macro- and Micro-Manipulation*, in *Journal of Business Ethics*, n. 57.

S.J. GRAY (1988), *Towards a Theory of Cultural Influence on the Development of Accounting System Internationally*, in *Abacus*, vol. 24, n. 1.

S.J. GRAY, H.M. VINT (1995), *The Impact of Culture on Accounting Disclosures: Some International Evidence*, in *Asia-Pacific Journal of Accounting*, vol. 21.

P.H. HEALY, J.M. WAHLEN (1999), *A Review of the Earnings Management Literature and Its Implications for Standard Setting*, in *Accounting Horizons*, vol. 13, n. 4.

M. JONES (EDITOR – 2011), *Creative Accounting, Fraud and International Accounting Scandals*, John Wiley and Sons, Chichester, England.

D. KUMAR KHATRI (2015), *Creative Accounting Leading to Financial Scams – Evidences from India and USA*, in *Journal of Accounting, Business and Management*, vol. 22, n. 2.

A.J. MALHOTRA (2013), *Curbing Creative Accounting: Role & Effectiveness of Ethics*, in *International Journal of Finance and Policy Analysis*, Autumn.

C.W. MULFORD, E.E. COMINSKY (2002), *The Financial Numbers Game: Detecting Creative Accounting Practices*, John Wiley & Sons, New York.

K.H.M. NASER (1993), *Creative Financial Accounting*, Prentice Hall International, Hemel Hempstead.

J.K. NIYAMA, A.M. GOMES RODRIGUES (2015), *Some Thoughts on Creative Accounting and International Accounting Standards*, in *Revista Universo Conabìl*, vol. 11, n. 1.

M. OMURGONULSEN, U. OMURGONULSEN (2009), *Critical thinking about creative accounting in the face of a recent scandal in the Turkish banking sector*, in *Critical Perspectives on Accounting*, vol. 20, n. 5.

P. ONIDA (1951), *Il bilancio d'esercizio delle imprese*, Giuffrè, Milano.

K. SCHIPPER, L. VINCENT (2003), *Earnings Quality*, in *Accounting Horizons*, Supplement.

F. TASSADAQ, Q.A. MALIK (2015), *Creative Accounting and Financial Reporting: Model Development and Empirical Testing*, in *International Journal of Economics and Financial Issues*, vol. 5, n. 2.

G. ZANDA (2007), *Il bilancio delle società*, Giappichelli, Torino.