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CREATIVE ACCOUNTING - A STUDY ON MOTIVES, TECHNIQUES AND POSSIBILITIES OF PREVENTION

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Abstract: Creative accounting can be described as an accounting practice that may or may not follow the accounting standards and principles. However, it deviates from the main idea of those standards and principles in order to present the desired picture of the business. Creative accounting is not illegal, but unethical since it doesn't meet the main objective of financial reporting – to present fair and objective picture of the business. The practice of creative accounting usually includes overstating assets, high stocks, decreasing expenses, changes of depreciation methods, or presenting provisions as an asset. Creative accounting techniques follow the changes of accounting standards, which are modified in order to reduce financial information manipulation. However, such changes in accounting standards often result in new opportunities for accounting manipulation. Although entities follow the accounting standards, they also use "loopholes" to enhance key financial ratios. Therefore, it is very important to adopt measures that will prevent the abuse of creative accounting practices. The aim of the paper is to present the main motives for financial information manipulation, as well as the most common techniques, and finally the measures that have to be taken in order to minimize creative accounting practices.

Keywords: Creative accounting, earnings management, accounting manipulations, financial statements

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INTRODUCTION:

Financial statements are the mirror of every company's business. They also represent a medium through which information on the financial position and business success of a company are communicated, primarily to external interest groups, which make different decisions based on such information. In order to be able to make the right decisions, the information contained in financial statements must be accurate and reliable. However, companies nowadays are increasingly resorting to "cooking" financial statements in order to present a more attractive business image and attract as many investors as possible. This is precisely why the concept of creative accounting has appeared. In other words, there is a distortion of financial information and presumptions of accuracy and reliability are brought into question. Increasing competition and the economic environment are just some of the reasons why companies resort to various accounting manipulation techniques, with the aim of concealing possible losses and presenting the business in the best possible light. This does not necessarily mean that

there is violation of accounting standards and legal regulations, but the so-called "loopholes" in laws are used to present a better image of the business. It should be noted that the practice of creative accounting is not illegal – which is why auditors often neglect it, but these are unethical procedures. The aim of this paper is to analyse the results of recent research on the topic of creative accounting and to present the main conclusions. The most commonly used methods of creative accounting will be shown, as well as possible solutions that would contribute to minimising the manipulation of financial information and encourage companies to act in accordance with basic ethical standards.

THE CONCEPT OF CREATIVE ACCOUNTING:

Accounting is one of the basic functions of each company. The financial information that it provides is very important for both managers and decision makers outside the company. The basic objective of financial reporting is to provide a fair and objective picture of the business to all interested stakeholders. This can often lead to a conflict of interest. Namely, on the one hand, investors expect reliable and credible financial information so that they can make the right decisions. On the other hand, are the companies that, due to increasing competition and economic conditions, are seeking to attract investors, because of which they often resort to unethical methods of creative accounting, that is, management of earnings. There are various definitions of creative accounting in the literature, but they all boil down to the same idea. Bhasin (2016) describes creative accounting as an accounting practice that may (or may not) adhere to accounting principles and standards, but deviates from what those principles and standards intend to achieve, in order to present the desired business image.

In other words, creative accounting is the process of transforming accounting information from what it actually is to what the company wants it to be, using the benefits (or loopholes) in the existing rules or by ignoring part of the rules. Creative accounting can also be described as a series of actions initiated by the company's management that affect the reported business result, which, however, do not bring true economic benefits to the company, but can instead result in great damages in the long term (Merchant, Rockness, 1994). Shah (1998), in turn, defined creative accounting as a process in which managers utilise the so-called loopholes and ambiguities in accounting standards to demonstrate financial success in a biased manner. Since creative accounting often does not violate legal rules, the question is whether it is good or bad.

This depends on the basic purpose for which it is used and the manner in which it is applied. Bhasin (2016) describes it in a very picturesque way: creative accounting is like a double-edged sword – management can either use it in a positive sense, or it can abuse it. Thus, the idea to present the business in a better light can ultimately result in a total loss of company image. The use of creativity in financial reporting can be described as playing with the elements of financial statements. Doing so may result in overestimation of the value of assets, high inventory levels, reduction in expenditures,

changes in depreciation methods, showing provisions as assets, etc. (Shahid, Ali, 2016). The techniques of creative accounting follow the changes of accounting standards, which are modified with the aim of reducing accounting manipulation. However, well-intended changes in accounting standards often result in opening up of new opportunities for accounting manipulations. Although companies apply accounting standards, at the same time they use "loopholes" to enhance the key indicators (Karim et al., 2016). Creative accounting can have a positive impact on a company's business in the short term, but in the long run it may result in decreased stock prices, insolvency, and even bankruptcy. It is the root of numerous accounting scandals, as well as many accounting reforms, which is why doubts in the transparency and honesty of financial reporting arise. For this reason, Bhasin (2016) emphasises the role of forensic accounting. Moreover, he points out that forensic accounting will be on the list of 20 most important and sought-after professions of the future.

3. OVERVIEW OF RECENT RESEARCH

Bhasin (2016) points out that many dimensions of creative accounting have been analyzed in previous research, but that no one has actually investigated what the people who prepare financial statements think about creative accounting, as well as their users. Based on this, a survey was conducted in India, which showed that the majority of respondents believe that creative accounting has adverse effects on financial reporting and that it is quite difficult to detect. Nevertheless, opinions are divided as to whether the practice of creative accounting is legal or not. The persons responsible for manipulating financial information and applying creative accounting are mainly managers and accountants, and the main motives for these practices are the benefits of manipulators, increasing competition and attracting foreign investment. Methods of financial statement manipulation most frequently include off-balance sheet financing items, changes in accounting policies and depreciation methods, other income and expenses, and changes in the value of money. Research has shown that a well-established accounting framework plays a key role in limiting creative accounting, and accounting standards should therefore be adapted accordingly in a way that limits the leeway of managers to decide between several accounting methods. Misuse of estimates in accounting can be reduced by a simple rule that an initially determined accounting policy must be used in all future similar circumstances, which would minimize the use of estimates and achieve consistency. It is also important to highlight the role of internal and external auditors in identifying and reporting unfair estimates, and emphasis the responsibility of detecting and preventing accounting manipulations. Auditors have to be changed periodically, they must not work under pressure from management, and it is necessary to hire independent directors and members of the audit committee, which are selected by shareholders. Companies need to integrate and promote accounting rules and regulations that will disallow individuals to find "loopholes" and thus gain benefits. Finally, companies should have a developed whistle-blower policy to

protect people who report financial irregularities to the top management. Karim et al. (2016) conducted a survey on the existence of a gap between accounting and auditing perceptions of creative accounting, and possible solutions to regulate such practices in Bangladesh. The survey has shown that there is no reason to punish either auditors or accountants for applying creative accounting. Accountants are only company employees that follow management instructions. Therefore, if management demands that financial statements are prepared in a certain way, accountants will primarily be concerned about keeping their jobs, and will follow the instructions accordingly. Therefore, management should be held criminally liable for the abuse of creative accounting. Accountants and auditors believe that national accounting authorities should give more attention to the code of ethics for accountants, which would have a positive impact on reducing the use of accounting manipulations. Based on the conducted research, it follows that the solution to the abuse of creative accounting lies in the imposition of penalties by national authorities, practicing forensic accounting in order to monitor such practices, emphasizing the code of ethics for accountants, and raising investors' awareness of such practice. Lau and Ooi (2016) conducted a study on fraudulent financial reporting in Malaysia, focusing on the creative accounting methods used and the motives for such actions. The research results showed that the most commonly used method of creative accounting was the overestimation of revenues through recognition of fictitious revenues from product sales to bogus customers. The main motive for this is increasing the company's capital, not settling debts and maintaining the level of capital. One of the key conclusions of the research is that auditors should review the effectiveness of their analytical and material procedures since there is a significant number of cases of creative or fraudulent accounting that remain undetected by the audit process. Also, the bodies that set accounting rules should reconsider whether managers have too much discretion in the application of accounting standards. In other words, the question arises whether they use this discretion to provide useful information to the decision makers or to obtain personal gain. It turned out that in most accounting scandals, unethical decisions of managers have led to significant adverse consequences for decision-makers and society as a whole. Therefore, managers should re-examine their own responsibilities and role in financial reporting. Furthermore, Alzoubi (2016) analyses the connection between company management and earnings management in Jordan. He arrived to the conclusion that ownership structure has a significant influence on earnings management. Thus, managerial ownership, institutional ownership, shareholders, as well as family and foreign ownership affect the quality of financial reporting, because they greatly reduce the ability to manage earnings. Write-off management is one of the frequently used creative accounting tools. Based on a study conducted in South Korea, Lee (2016) came to the conclusion that write-off management is the ideal item for manipulating accounting information because it is based on management's estimates. Companies usually manipulate write-offs of receivables to avoid reporting

losses, to maintain an equal level of earnings over the years, and to meet the analysts' forecasts. Mindak et al. (2016) investigated whether companies use creative accounting techniques to meet the analysts' forecasts and exceed last year's earnings and whether the market rewards or punishes such manipulations. The conducted research has shown that all the companies that have managed to beat the targets have used creative accounting methods to artificially increase earnings and have been rewarded by the market for doing so. In contrast, companies that have managed earnings in order to reduce them (by increasing reserves, for example), so that they barely meet the set goals, were not rewarded. The reason is that most of the targeted earnings are actually determined by analysts' forecasts – so the most important goal of earnings management is to beat the forecasts, because companies that succeed in doing so are considered "good" companies. Thus, companies trying to maintain the same level of earnings over the years are not considered "good" since they do not surpass the expectations. Inaam and Khamoussi (2016) have explained the association between audit committee and audit
quality itself and the practice of earnings management. The basic function of corporate governance in financial reporting is to ensure compliance with accounting standards, and to provide reliable and credible financial information in financial statements. Therefore, good corporate governance should ensure effective controls and prevent unethical management behaviour. Although it is to be assumed that quality corporate governance, audit committees and quality audit implementation affect the limited use of various earnings management techniques, this study showed a negative relationship with the practice of earnings management. Research carried out by Shahid and Ali (2016) showed that creative accounting has a significant impact on fair and objective financial reporting in Pakistan. In order to prevent the manipulation of financial information, it is necessary to put emphasis on corporate governance and the strengthening of ethical values. Limited and minimal use of creative accounting in a positive sense should actually not affect the quality of financial reporting. Since most research in the field of creative accounting tries to explain how it affects business, Goel (2017) conducted a study on the impact of creative accounting on stock prices in the market. The results showed that companies use accruals for manipulating financial information, most often in periods when financial markets are uncertain about the prospects of the business of such companies in the future.

4) MOTIVES, TECHNIQUES AND METHODS OF LIMITING CREATIVE ACCOUNTING

The basic idea of creative accounting is based on finding the so-called loopholes in laws and accounting standards with the intention of enhancing financial statements and presenting the business in a positive light. Creative accounting can have a positive impact on business, but only when it is applied in a positive sense and in a minimal scope. However, it often happens that companies' cross boundaries of minimalism and abuse

such practice, which can lead to fatal consequences. One thing is certain, creative accounting most often has a negative effect on financial reporting. In most cases, company management is responsible for the manipulation of financial reporting, as their instructions are followed by the employees responsible for financial reporting.

The main motives for applying creative accounting are:

a. Obtaining personal gain
b. Competition
c. Attracting investors
d. Increasing or maintaining the level of capital
e. Buying time for not settling debts
f. Beating analysts' forecasts about future company performance

In order to present their business in the best possible light, companies use various techniques to manipulate financial information. Manipulations usually occur where accounting standards require accounting estimates.

The most widely used creative accounting techniques are:

1. Manipulation of off-balance sheet financing items
2. Changes in accounting policies and depreciation methods
3. Manipulation of other income and expense items
4. Changes in the value of money
5. Overestimation of revenues by recording fictitious sales revenues
6. Manipulation of receivables write-offs
7. Manipulation of accruals.

Since creative accounting is increasingly being used in a negative sense, resulting in numerous accounting scandals with huge consequences, it is necessary to establish efficient methods that will limit or minimise manipulation of financial information.

Efficient techniques for preventing creative accounting include:

a. Adaptation of accounting standards in terms of limited use of estimates and consistency in the application of accounting methods
b. Recognising and insisting on the role of internal and external audit in identifying and reporting unfair estimates, and preventing accounting manipulations
c. Change of audit service providers from one accounting period to another
d. Hiring independent directors and members of the audit committee
e. Establishing effective corporate governance controls
f. Company persistence in developing a whistle blower policy
g. Continuously making employees aware of the code of ethics
h. Placing emphasis on the development and application of forensic accounting
i. Making investors aware of the practice of manipulating financial information
j. Consistent enforcement of penalties by national authorities.

5. CONCLUSION

Financial statements are used to communicate the business, expressed in figures, to all interested stakeholders. The main objective of financial reporting is to provide a fair and objective picture of the

business, taking into account the fundamental accounting principles and assumptions. However, accounting standards often allow and require various accounting estimates, which can lead to manipulation of financial information. Creative accounting can be described as a process in which managers exploit "loopholes" and ambiguities in accounting standards to demonstrate financial success in a biased manner. Looking at the short-term, manipulating financial information can have a positive impact on business. But in the long run, it usually results in a fall in stock prices and bankruptcy.

Most often, managers are the ones responsible for manipulating financial information, as it is they who provide guidance to their subordinates regarding financial reporting. The main motives for this are obtaining personal gain, attracting investors by presenting a false image of their business, struggle with the competition and economic conditions, increasing capital, buying time because of unpaid overdue liabilities, and beating analysts' forecasts regarding business performance so as to achieve overall benefit for the company.

In order to present business in a positive light, companies use various methods of creative accounting. The basis for manipulative procedures lies in accounting estimates that are permitted within accounting standards. The techniques used in creative accounting relate to manipulation of off-balance sheet financing items, changes in accounting policies and depreciation methods, manipulation of other income and expense items, changes in the value of money, overestimation of revenues by recording fictitious sales revenues, manipulation of receivables write-offs, and manipulation of accruals. If it is implemented in a minimal scope and with positive intent, creative accounting can be considered good practice. But since it is often misused, it is necessary to insist on measures that will minimize the practice of manipulating financial statements in order to prevent false financial reporting. Such measures include adaptation of accounting standards in the sense of limiting the use of accounting estimates, and establishing consistency in the application of accounting methods. It is necessary to recognise the role of internal and external audit in identifying and reporting unfair estimates, and preventing accounting manipulations. Moreover, it is desirable to use services of different auditing companies in different accounting periods. Additionally, it would be good for companies to hire independent directors and members of the audit committee, establish effective corporate governance controls, persist in developing a whistle-blower policy, and continuously work on raising employees' awareness of the code of ethics. It is also necessary to raise awareness of investors about the application of creative accounting practices and persist in the development and application of forensic accounting.

Furthermore, national authorities should consistently enforce penalties. Finally, the use of creative accounting certainly cannot be completely removed, but it can be minimized using various solutions.

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