THE NATURE, TECHNIQUES AND PREVENTION OF CREATIVE ACCOUNTING: EMPIRICAL EVIDENCE FROM NIGERIA

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Abstract

The study is on the practice of creative accounting, its nature, techniques, and prevention. Creative accounting is viewed as the exploitation of accounting concepts and GAAP for gaining various advantages and for deceitful purposes. The survey method was adopted and 180 questionnaires were distributed and 170 were collected and analyzed using the Chi-square statistic in the Predictive Analytic Software (version 19). It was revealed that the practice of creative accounting is always a deliberate attempt to gain undue advantage by management and also to deceive the stakeholders of the firm, by presenting a good view of the financial position of the firm. Punitive measures against the culprits were revealed to be one of the means of stopping the practice. The study also revealed that the new international financial reporting standard will go a long way in stopping the practice in Nigeria.

Key words: Creative Accounting, Forensic Accounting, Earning Management, GAAP**,**

1. INTRODUCTION

Financial accounting reports are produced to show the true and fair state of affairs of business entities so that stakeholders and other users of such information can take informed decisions. In order to ensure uniformity in preparation and presentation of such reports, Generally Acceptable Accounting Practices (GAAP) are prescribed within the accounting profession and the business world by regulatory agencies in the accounting profession in Nigeria this include the Nigerian Accounting Standards Board (NASB) and the Companies and Allied Matters Act (CAMA 1990 as amended). However, the accounting process and regulatory framework as prescribed by International Accounting Standards (IAS), and in Nigeria, the Statement of Accounting Standards (SAS), CAMA 1990, Banks and Other Financial Institutions Act (BOFIA), leave room for discretionary judgments by the accountant.This involves resolving conflicts between competing approaches to the manner in which results of financial events and transactions are presented. This flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities as negatively practiced by the less scrupulous elements of the accounting profession are popularly referred to as *creative accounting* (Jameson, 1988). The act is characterized by excessive complication and the use of novel ways of characterizing income, assets, or liabilities (Ghosh, 2010) with the intent to influence readers towards the interpretations which are desired by the authors of the reports. Though called *creative accounting* in the UK, it is known as *Earnings management* in the USA. Other terms used are *"aggressive" or "innovative" or "Cosmetic" or "deceptive"* accounting.

The persistent use of creative accounting has led to the collapse of several corporations and/or major scandals. Examples of major corporate collapses include Enron, Adelphia, Tyco, and Fannie Mae in the USA, Lehnan Brothers, and Satyaro in India. Other scandals include American Insurance Group (AIG) in the USA (http://knowledge.wharton.upenn.edu/article/1180.cfm), and Cadbury Nigeria PLC (the Bunmi Oni saga) in Nigeria. These studies support Griffiths' (1986) assertion 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.*

The **problem of this study** is that the debilitating effects of creative accounting practices on the truthfulness and fairness of financial reports and hence the users of accounting information and their investment decision-making effectiveness become threatened on a daily basis. the following **research questions** become necessary for the study to answer:

1. What is the nature of creative accounting and what factors drive the practice in organizations?
2. What measures can be used to prevent the practice of creative accounting in businesses?

It is, therefore, the objective of this study to evaluate and provide insights into the nature, techniques, motivating factors and the prevention of creative accounting practices within businesses with the ultimate aim of aiding the decision-making of stakeholders. Another objective of the study is to investigate the perception of accounting experts about creative accounting practices. In order to give focus to the study, ten variables in line with the questions in the research instrument were tested. The paper is divided into five parts. Part one is the introduction, part two is the literature review which comprises of the conceptual clarifications of some relevant terms and the theoretical framework. Part three explains the methods of study while part four is the data presentation and discussion of findings. Part five is the conclusion.

2. LITERATURE REVIEW

2.1. Conceptual clarifications

Extant literature is rife with different definitions of terms used in relation to creative accounting. The following related terms are considered as generally understood in literature – creative accounting, earnings management, statement of accounting standard (SAS), Generally Accepted Accounting Practice (GAAP), accounting ethics, and forensic accounting.

Creative Accounting: The term "creative accounting" was first used in 1968 in the film *The Produce* by Mel Brooks (http://chaumurky.net/criterion/indept-184.html). When no fraud is involved, creative accounting in its strict sense involves the transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulations. Ghosh (2010) defined creative accounting as the transformation of accounting figures from what they actually are to what perpetrators desire by taking advantage of the existing rules and/or ignoring some or all of such rules/guidelines. They are, therefore, accounting practices that may or may not follow the letters of the rules of standard accounting practices but certainly are far from the spirit of those rules. Sen and Inanga (n.d.) see creative accounting as referring to accounting techniques in which financial information is distorted by window-dressing and various manipulations. This is done to present, theoretically, a better financial picture by either increasing or reducing profit as the case may be, by putting forward a misleading appearance of capital size or structure and by concealing relevant information from existing or potential investors.

Earnings management: This occur when managers use the privilege of judgment in financial reporting and in structuring transactions to alter financial reports in order to either mislead some stakeholders about the underlying economic performance of a company or to influence contractual outcomes that are dependent on the reported accounting numbers (Healy & Wahlen, 1999). It usually involves artificial increase (or decrease) of revenues, profits, or earnings per share figures through aggressive accounting tactics. They are usually done to satisfy projections by financial analysts. It is a form of fraud as it falls *outside of the bounds of generally accepted accounting practice.*

Generally Acceptable Accounting Practice (GAAP): These are the overriding accounting principles, standards, and procedures that companies in follow when compiling their financial statements, GAAP is issued by the Financial Accounting Standards Board (FASB) in the USA and covers items such as revenue recognition, balance sheet item classification, and outstanding share measurements.

Statement of Accounting Standard (SAS): SAS are issued in Nigeria by the Nigerian Accounting Standards Board (NASB). As at date (2011), 33 statements have been issued covering different aspects of financial transactions and industries.

Accounting ethics: This concerns issues regarding right and wrong in the practice of accounting. The deontological view is that moral rules should apply to actual actions while the teleological view holds that an action should be judged on the basis of the moral worth of the outcome according to Ruland(1984). Ruland (1984) also posits that the *duty to refrain* implies avoiding the bias inherent in creative accounting while the *duty to act* involves pursuing the consequence which creative accounting is to achieve. Ruland sees the *duty to refrain* as more important (Amat et al., 1999).

Forensic accounting: This is investigative accounting done by forensic accounting consultants to solve problems usually in court. It deals with sensitive matters that involve complex financial matters, incomplete records, deception, lawyers, enforcement agencies and the legal system (www.deloitte/forensicaccountinginvestigation.htm). Amat and Gowthorpe (n.d) posit that the potentials for creative accounting exists in six major areas: a dearth of regulation, the timing of some genuine transactions, regulatory flexibility, the use of artificial transactions, a scope for managerial judgment in respect of assumptions about the future and the reclassification and presentation of financial numbers. Lungu et al. (2009) identified the following in their 'not exhaustive census of techniques': (i) manipulation of tangible assets via the practice of "subjective depreciation" and lease-back arrangements, (ii) goodwill – via underestimation of assets purchased which leads to increased goodwill, (iii) depreciation – via using different methods and/or review of useful life of an asset, (iv) inventories – the manipulation of which affects subsequence years, and (v) provisions for liabilities and charges – are used as effective tools for "leveling" financial outcomes. The creative accounting mechanisms which involve tangible assets, equity, minority interests, loans and customers' claims usually have an impact on the balance sheet (Lungu et al., 2009).

Drivers of creative accounting

Mulford and Comiskey (2002) posited that managers play *the numbers game* in exchange for a variety of expected rewards. The rewards may be any of the following: lower corporate borrowing costs as a result of an improved credit rating, favourable effect on share prices, political gains, and/or incentive compensation plans involving stock option or profit-sharing for top management and key employees which are tied to income measurement. Amat and Gowthorpe (nd) reported that the existence of tax levies based on income is one of the factor motivating creative accounting. Secondly he noted that where management is able to report stable earnings obtain the confidence of shareholders and employees another is the incidence of *'big bath'* accounting whereby an organization that is currently making a bad loss decides to maximize the reported loss in that year so that results of future years will look better. Other motivations include the positive effects which income smoothing has on securities valuation and the reduction of risk for financial analysts; where management observes a gap between analysts' expectation and the actual performance of the company and when major capital market transactions are being expected. . Another motivation is the need to create an appearance of a good profit trend so that the company can be able to raise capital through the issue of new shares, or resist takeover bids, or offer its own shares in takeover bids. A study by Amat and Gowthorpe (n.d) in Spain between 1999 and 2001 suggests that the direction of creative accounting (i.e. whether Reported earnings $^{>}_{<}$ Adjusted earnings) could be related to the general economic conditions prevailing in the country.

Ghosh (2010) suggests that in detecting and preventing creative accounting, the following concepts must be considered: Nonrecurring accounting shenanigans (e.g. "nonrecurring items"), Pro Forma earnings, spot the habitual users of nonrecurring items, divide the figures by sales and obtain percentages to see trend, and use Nonrecurring expense ratios. The emphasis on nonrecurring expenses here is because the more expenses that can be defined as nonrecurring, the higher the reported earnings. Ghosh further observed that firms that are known for fraudulent financial reporting trend are characterized by weak internal control or a family relationship among directors and officers and a board of directors dominated by individuals with significant equity ownership and inadequate experience and no audit committee.

3. METHODS OF STUDY

This study is an exploratory one that has benefited from both primary and secondary sources of information. In obtaining primary information, the study adopted the expert opinion survey method whereby the views of experts in the accounting profession were sought whether they agreed with or differ from information earlier obtained from literature about the phenomenon under consideration. The use of perceptual measures is known to be characteristic of most behavioural researches (Idris, 2012; Ogundele, 2000; Gray and Wert-Gray, 2000). This cross sectional study drew samples from the cities of Lagos and Port-Harcourt the state capitals of Lagos and Rivers States of Nigeria on the West coast of Africa. The population comprised of practicing professional Accountants (Chartered, Certified and Cost and Management Accountants) and University Teachers of Accounting in all the universities within the two states. A sample of 180 people was selected to which questionnaires were administered of which 170 were returned, found usable and hence analyzed giving an effective response rate of 94 percent.

In obtaining the research instrument, the identified variables of interest from literature were arranged to form a fully structured questionnaire. The questionnaire had a total of 10 items. A five-point Likert rating scale was adopted for coding the responses and mapping them into numeric values. The content validity test was used to test the instrument for validity and this was determined using expert opinion. Two senior university teachers of Accounting validated variables used in the research instrument. In order to ensure that the variable is relevant to the accounting practitioners' environment in Nigeria, the instrument was sent to twelve accounting practitioners in Lagos. Based on their views, some adjustments were made to the questionnaire before its administration (Osuagwu & Obaji, 2009; Churchill & Brown, 2004). The Statistical Package for Social Science (SPSS, 19) was used for the analysis of data collected. For the reliability test a Cronbach's Alpha of 0.71 was obtained from the instrument. The instrument can therefore be said to be reliable (Carmines & Zeller, 1980).

4. DATA PRESENTATION AND DISCUSSION

Presented below in Table 1 are the keys to the research instrument.

Table 1: Keys to the research variables.

VAR001	The transformation of accounting figures from what they are to what perpetrators desire by taking advantage of the existing rules and/or ignoring some is for the purpose of gaining personal advantage.
VAR002	The generality of accounting concepts and GAAP (Generally Accepted Accounting Principles) create a gap that can promote creative accounting
VAR003	The numbers game played by Management (creative accounting) is in exchange for a variety of exceptional rewards.
VAR004	Management deliberately engages in income smoothing and income adjustment to mislead stakeholders of the firm and hence obtain personal gains.
VAR005	The direction of creative accounting whether towards reported earnings or adjusted earnings is related to the general economic condition prevailing in the country.
VAR006	Frequent changes in accounting policies might suggest progressive creative accounting practices.
VAR007	The prospectus issued by organizations in Nigeria ignore notes to the financial statements especially with regards to disclosures and accounting policies
VAR008	The new International Financial Reporting Standard (IFRS) will help prevent creative accounting in Nigeria.
VAR009	The setting up of technical departments by the big accounting firms will assist in preventing creative accounting practices in incorporated firms.
VAR010	Punitive measures taken against any firm found in the act of creative accounting will help prevent future re-occurrence of it.

Table 2 below shows the mean ranking of the respondents' responses to each of the questions in the questionnaire.

Table 2 : Mean ranking of respondents responses.

Var0001	4.1118
Var0002	4.000
Var0005	3.8824
Var0004	3.7765
Var0010	3.7765
Var0003	3.4412
Var0008	3.4412
Var0006	3.2353
Var0007	3.1000
Var0009	2.7824

The above mean ranking shows the average responses to the practice of creative accounting: nature, technique, and prevention. Ten important variables relating to creative accounting were selected for test and ranking. The SPSS (19) was used for the analysis .The responses depict the level of importance attached to each variable, the higher the mean the more the import of such practice in the financial sector. There is a generally highest average response that "The transformation of accounting figures from what they are to what perpetrators desire by taking advantage of the existing rules and/or ignoring some is for the purpose of gaining personal advantage rank first suggesting that this variable remain most pivotal to the practice of creative accounting. It was equally accepted that the generality of accounting concept and GAAP (Generally Accepted Accounting Principles) create a gap that can promote creative accounting this show a high mean acceptance level of 4 and hence ranked second. "The direction of creative accounting whether towards reported earnings or adjusted earnings is related to the general economic condition prevailing in the country "rank next.

These three variables are ranked to be the most important factors among variables tested for creative accounting Of the tested variables of creative accounting "Punitive measure taken against any firm found in the act of creative accounting will help prevent future recurrent of it" rank middle this mean that the best way to prevent the practice of creative accounting is a punitive measure against found in the act. However, the variable on "The new International Financial Reporting Standard (IFRS) will help prevent creative accounting in Nigeria" received moderate mean ranking by the respondents. There was low average agreement among top managers and accountant in the financial sector that "frequent changes in accounting policies might suggest progressive creative accounting". .it was also lowly agreed on that "The prospectus issued by the organization in Nigeria ignore notes to the financial statement especially in regard to disclosures and accounting policies" . Conclusively there was a poor mean agreement on the variable that "The setting up of technical department by the big accounting firm will assist in preventing of creative accounting in public firm"

Hypotheses Testing

The researchers identified ten variables representing the practice of creative accounting: nature, technique, and prevention. The variables were tested differently using the chi-square techniques.
It was observed that variables one to ten were all significant using the Asymp. sig and using the chi- square test this suggest that all the variables are very significant factors for the test

		X^2cal	X^2tab	Decision	Sig test
1	VAR001	49.635[a]			0.00
2	VAR002	49.635[a]	3.84	Accept H_1	0.00
3	VAR003	87.188[a]	3.84	Accept H_1	0.00
4	VAR004	36.894[a]	3.84	Accept H_1	0.00
5	VAR005	12.753[a]	3.84	Accept H_1	0.00
6	VAR006	91.553	3.84	Accept H_1	0.00
7	VAR007	58.471[b]	5.99	Accept H_1	0.00
8	VAR008	58.471[b]	5.99	Accept H_1	0.00
9	VAR009	40.588	3.84	Accept H_1	0.00
10	VAR010	88.588	3.84	Accept H_1	0.00

5. CONCLUSION AND RECOMMENDATIONS

This study revealed that the practice of creative accounting in whatever form is an attempt to gain advantage of a form. The study shows that the current GAAP create a gap that can permit the practice of creative accounting. However, the study also revealed that the new International Financial Reporting Standard will go a long way to reduce the practice, since it covers more areas that the former practice. It was equally revealed that one of the best ways to prevent the practice of creative accounting is to enforce both preventive as well as strong enough punitive measures on those that engage in the practice. it was recommended that effective rules and regulation of accounting practice should be put in places within the organization to forestall the incidence of creative accounting also it was recommend that GAAP usage should be subjected to basic SAS and IAS standard. Moreover punitive measure should be taken against t those executive found culpable in the act of creative accounting

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