Creative Accounting in Financial Reporting

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Abstract

One of the great financial accounting challenges – creative accounting can be investigated from several perspectives: accounting, ethical, legal or psychological. The paper aims to achieve, based on a qualitative analysis, a synthesis over the perception of the creative accounting techniques from an ethical perspective, but also to identify the possible motivations that can be the basis for these techniques use by the managers and the professionals in the financial field. In general, creative accounting is seen as a negative technique, as a method of manipulating financial statements, which can negatively influence, in particular, the decision-making process and, in the long term, even the company itself, but which can be limited by implementing some strict reporting standards, independent audits, ethical education and by the use of innovative technologies. Among the identified motivations, we found the desire of the management to reach the performance standards imposed by the capital holders, obtaining capital under favourable conditions, reducing the tax bases, meeting certain criteria necessary for listing on the stock market, covering some faulty management decisions.

Key words: creative accounting, creative accounting techniques, ethic in accounting, accounting manipulation, creative accounting motivation
J.E.L. classification: M41

1. Introduction

Although accounting continues to represent the main provider of financial-accounting information to companies' stakeholders, and the increase in competitiveness and profitability both domestically and internationally requires accurate, compliant, reliable and standardized reporting (Hýblová et al., 2022), sometimes they are reluctant to report realistically and faithfully (Aygun, 2013), accounting no longer being the mirror of all transactions that companies are carried out. The financial and non-financial statements presentation tends to be influenced by the divergent interests, objectives and professional views, corporate management and equity holders (Drabkova & Martin, 2022).

The numerous financial scandals generated by the use of different creative accounting techniques, keep researchers focused on this subject, in an attempt to determine both the factors that underlie the decision to use them, and the effects that these techniques can have on the company but also on the economic-social situation, as a whole. Motivated by the concern that investors attach to financial results, managers and financial accounting professionals manipulate the numbers in such a way that they reflect the economic situation according to their own interests and less the true image of the company. Despite the negative perception of these manipulation techniques, there are also opinions that support creativity in accounting as a source of innovation within companies. This creativity is perceived as the art of searching for, identifying, adapting and implementing unconventional procedures, innovative ideas and original solutions capable to generate innovation and added value at the organizational level (Vartiak & Garbarova, 2024). The problem of creative accounting is not limited to the corporate level, but can be analysed at the national level, the European states that joined the Economic and Monetary Union (EMU) used such techniques, or at the regional or governmental level (Goto & Yamamoto, 2023). Among the motivations encountered, one can identify the desire to present improved returns, results in line with the established objectives, the desire to justify certain negative situations.

At the extreme limit of creative accounting is economic crime (Zbigniew, 2019), which assimilates serious accounting errors and fraud with major ramifications, which tends to be more of an economic crime than a tax optimization technique, with significant impact on companies globally. In order to counteract these practices, it becomes impetuously necessary to analyse not only the external variables that settle companies to integrate such techniques, but also the internal variables, capable of explaining the attitude, intention and behaviour of managers and professionals in the face of this phenomenon. Ethics in accounting is the link, the point of balance between the innovation allowed in reporting techniques and the fulfilment of the fundamental principles of business ethics.

The purpose of this study is to identify the way in which managers and accounting professionals currently perceive the creative accounting techniques as well as the possible motivations underlying the adoption and use of such techniques of manipulation and distorted presentation of realities through the lens of ethical issues. The research is established on an empirical investigation study based on a series of semi-structured interviews with managers and professionals from the financial - accounting field of some Romanian companies active in different fields. The work identified a negative perception of the creative accounting techniques of those interviewed, but also a series of motivations that could be the basis of the decision to use them within the companies.

The main objectives are to identify the acceptance of the creative accounting techniques, both on the part of professional accountants and managers in their dual capacity: both users of financial - accounting information but also providers of it, as well as the main motivation that lies at the basis for these technique adoptions. Along the stated logical line, we thus identified two specific objectives:

1. Analyse the perception over the creative accounting techniques
2. Describe the motivation of the pro-creative attitude in accounting under the influence of ethical principles

Based on a critical content analysis, the primary data resulting from the semi-structured interviews were thus processed. The study addresses the acceptance of creative accounting techniques as well as the motivation among professionals and managers that can underlie the use of such tools, being structured in five sections. The introduction brings the motivation and the research questions to the reader attention. In the specialized literature analysis, a theoretical perspective of different researcher opinions who studied the issue of creative accounting is offered, being the theoretical basis on which the research hypotheses were established. Section number three presents the research methodology, the research sample, the limitations of the paper as well as future research directions. In section number four, the results obtained are described in details and the results of similar studies are discussed. The last of the sections highlights the conclusions as well as the research implications.

The originality of the study results from the presentation of new realities regarding the phenomenon of creative accounting from an ethical point of view, but also the motivations that can lead different categories of interested parties to integrate them into current techniques within companies.

2. Theoretical background

Accounting, as a social science, presents multiple facets, being both a science and a technique, but it can also be seen as a historical phenomenon, art, stake or social game (Cernușca et al., 2016). In the specialized literature, creative accounting practices are presented under various names, the most widespread being earnings management, especially in the USA (Breton & Taffler, 1995; Khatri, 2015), but also engineering financial, fraudulent accounting (Škoda et al., 2017) or bad accounting (Balaciu et al., 2017).

Rahman (Rahman et al., 2023) defines creative accounting in terms of sophisticated accounting skills and practices that are permitted by current regulations. Based on these refined techniques, the company's management presents the reports in a convenient and distorted way. The term creative accounting tends to be attributed, especially to accounting manipulation techniques involving, in particular, balance sheet elements and less performance indicators presented in the profit and loss account (Škoda et al., 2017). Creative accounting is a tool that bypasses the spirit of standard accounting rules and procedures and allows the permutation of accounting practices (Olojede & Olayinka E., 2021), and which generates challenges for investors to decipher.

This explains the great failures of companies such as Enron Worl.com or Arthur Anderson, which, despite their stability and financial dimensions, have failed due to innovative accounting practices: inadequate financial reporting, the use of financial indicators, lack of ethics, inadequate governance procedures (Rahman et al., 2023 Feleagă & Feleagă, 2006).

In defining creative accounting, the authors make a clear distinction between two practices: fraud aimed at presenting the entity in a favourable manner and changing the equity value by not applying reporting standards (Hýblová et al., 2022), creativity being used either to present in a more attractive manner for investors or to influence, or to distort financial reports, and financial records are treated in an unethical way, at the limit of the legal regulations in force (Feleagă, 1996). Kováčová (2022) identified some of the processes and strategies by which management directs income and reported values are all more varied: valuation of properties, erroneous entries in voluntary mode in accounting, sales handling, earnings management.

Abed (2022) identifies four of the essential creative accounting components: the ownership form, the internal control type, the business ethics level , the reporting quality and Blazek (2023) puts corporate governance as the main obstacle in the spread of creative accounting techniques, considered to be lacking in professional ethics and fairness to interested parties, an exercise of managerial power with the aim of undermining the authority of regulatory bodies in the financial-accounting field.

Due to the lack of coercive measures against these techniques and their worldwide acceptance, creative accounting opens certain loopholes (Gupta & Kumar, 2020) that exist in the regulations and rules that govern the preparation and financial – accounting reporting and can throw very lightly towards tax fraud or economic crimes with a negative impact on economic life, as a whole.

The motivations underlying the adoption of creative levers in accounting are increasingly diverse (Feleagă & Malciu, 2002) and dynamic: the desire for personal gains, results comparability, attractiveness for investors, company capitalization, postponement of payment terms for debts.

The main creative accounting methods identified by researchers include, among others: revenue manipulation – either delaying or accelerating the time of revenue recognition – cost manipulation – either delaying the time of expense recognition or overestimating assets – excessive use of provisions – diminishing liabilities in profitable periods to transfer during difficult periods in terms of results.

The implications and risks associated with these techniques are found both at the micro level, the trust of capital holders, the stability of the financial market, the damage to the company's reputation, but also at the macroeconomic level: negative impact on the financial markets through erroneous decisions by investors, the possibility of massive frauds by companies.

The measures that can be taken to limit and counteract these practices are the prerogative of international regulatory bodies through strict standards and guidelines for financial reporting, tough measures capable of combating financial manipulation. And auditors have a crucial role in detecting creative practices that raise moral issues, straddling the boundary between innovation and deception (Patterson, 1987).

Circumstances and organizational problems are perceived differently, as well as decision-making processes, they are based on ethical premises, taken from the organization's hierarchy of values, creative accounting being linked not only by general ethics (Faruq, 2014), but especially by ethics norms accounting (van Helden et al., 2023). Ethics in creative accounting involves finding a balance between innovation permitted by accounting rules and regulations and adherence to fundamental ethical principles (Akenbor & Tennyson, 2014).

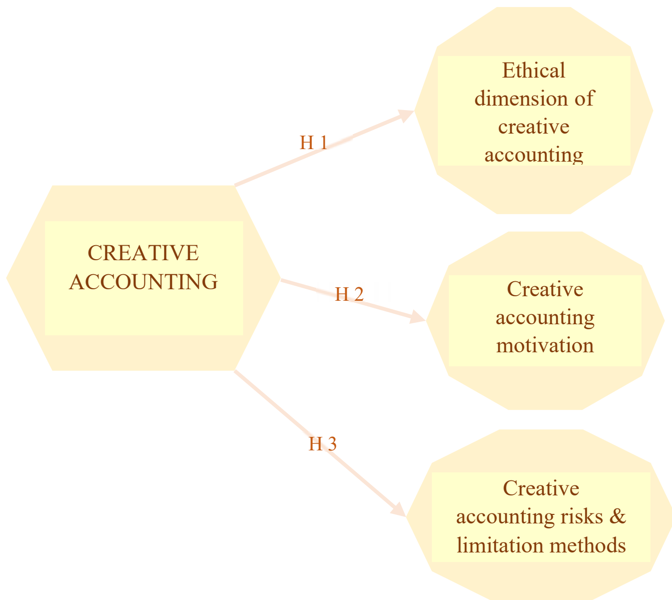
3. Research methodology

In order to fulfil the research amin objective, namely to investigate the ethical dimension of creative accounting techniques and the motivation to use such techniques, we focused our attention on obtaining empirical data, through semi-structured interviews, followed by a critical analysis.

To achieve the objectives, we formulated the following research questions:

1. What is the understanding of managers and accounting professionals on creative accounting techniques from the concept ethical perspective?
2. What are the motivations underlying the use of such techniques in financial reporting?
3. What can be the risks associated with the use of such techniques but also the methods of combating them?

Figure no. 1 Research Questions



Source: made by authors

The qualitative analysis starts from empirical data obtained from semi-structured interviews, method also used by Kokina (2019) and Cooper (2019). Invitations were sent to 32 top managers and accounting professionals and positive responses were received from 12 of them. To ensure the optimal level of data saturation, companies from various fields of activity were selected (Fugard & Potts, 2014).

The interviewees were told in the participate invitation that it is voluntary, they are not remunerated and that both their data and those of the companies are anonymous. The interviews took place in Romanian, as their mother tongue, and notes were taken during the discussions, some of the interviewees did not agree with the interviews recording, so it was desired to preserve the unitary character of the entire data collection process. The average duration of an interview was 46 minutes.

As the interviews were carried out, the answers given by the participants registered a tendency to repeat themselves, so the data saturation level was reached (Fugard & Potts, 2014). At the interviews end, the received answers were analysed, grouped according to the topic addressed and the main ideas were extracted and then the research results were determined by interpreting these data.

The main limitation of this stage is that the data comes from a limited number of professionals and managers, from a certain geographical area, the answers can be affected by the historical, cultural, economic or social factor. As a next research direction, we aim to validate the result with a widespread questionnaire of a larger scale through a quantitative analysis.

4. Findings

Creative accounting is represented by a set of tools and techniques backing the management to support an to improve the company image and to provide information in such a way that it supports its interests.

Creative accounting is based on the gaps or on the flexibility of the force accounting regulations and on the interpretation of the rules with the aim of presenting a favourable organization financial image, an aspect that is not necessarily illegal, but which can raise ethical issues: *there are provided a number of perfectly legal tools to develop creative accounting techniques: accounting options, accounting policies, accounting estimates, forecasts* and involves *the deliberate manipulation of financial figures to satisfy the needs of interested parties*. The line between creative accounting and tax fraud is an extremely unstable one and requires a thorough understanding of accounting standards and rules, while fraud involves the deliberate violation of existing rules and regulations, creative accounting is based on the flexible interpretation of existing rules.

In general, creative accounting is seen as a negative technique, as a method of manipulating financial statements, which can negatively influence, in particular, the decision-making process of different categories of interested parties and, in the long term, even the company itself, but which can be limited by implementing strict reporting standards, independent audits, ethical education and the use of innovative technologies. The vast majority of those interviewed believe that tax and accounting legislation are the main ones responsible in terms of the opportunities to use creative accounting techniques offered: *although the accounting rules are quite strict, we can choose certain policies, we have freedom in the game of options, in the description certain phenomena*, *despite the international standards adopted, there are still certain gaps in the legislation that still leave room for interpretations*.

At the basis of the motivation to use creative accounting are the reporting pressures (meeting the expectations of shareholders or creditors, avoiding the violation of financial conventions), performance-based compensation (performance-related remuneration policies can encourage the attitude towards the manipulation of situations) (*if the remuneration would does according to the achievement of the denominator performance indicators, we would most likely try to present the data in the most favourable way)*, fiscal pressure (creative accounting can be used to reduce the tax burden of companies), (*we try to optimize our tax policy, within the limits of the law)*, the need for financing (the embellishment of the financial statements can make the company attractive to creditors or investors), (*sometimes it is necessary to embellish the data in order to comply with certain loan contractual clauses or to obtain additional financing*, *to attract investors, the image of the company needs to be improved)*, market pressure – (*we have to be very careful about the reported figures so that the company to be attractive to potential investors)*.

Regarding the specific techniques of creative accounting, we have identified: the provisions manipulation *(depending on the company interest, certain provisions can be constituted*), the convenient use of accounting policies (*the choice of different depreciation methods is a perfectly legal but also ethical technique and not affects the quality of reporting, quantitative or value overvaluation of inventory can be considered a creative method*) and revaluation of assets (*we revalued assets to increase the company value*).

In general, creative accounting is seen as a negative technique, as a method of manipulating financial statements, which can negatively influence, in particular, the shareholders *decision-making process* (*in the past we encountered problems due to false information transmitted by to some partners, presenting a distorted financial picture could affect several partners*) and, in the long term, even the company itself (*if we reported distorted figures, we would lose our credibility among investors and among business partners as well*), but which can be limited by a strict reporting standards discharged (*the standardization of financial reporting standards at the international level could help to reduce the existing discrepancies between different countries in the use of these practice, the standardization of reporting could reduce the flexibility interpretation, stricter guidelines on reporting rules could prevent manipulation*), clear corporate governance policies (*the company's governance policy is clear against such practices*), independent audits (*strict reporting and auditing standards can limit these practices, a rigorous and professional audit can help to detect and prevent abuses, the competence and integrity of the auditor can help to detect creative practices*) along with effective internal controls (a rigorous internal control limits the risk of presenting erroneous data) , ethical education (*professional education is essential to limit the phenomenon, it is important to ethically train accountants and managers not to use these practices, there is a very strict code of ethics at the company level that promotes transparency, an organizational culture focused on ethics and responsibility can at least discourage these practices*) and the innovative technologies (*I believe that automation and artificial intelligence will have the ability to recognize certain methods of manipulation, automation of accounting processes reduces the flexibility of interpretations, technology will be able to detect creative techniques, artificial intelligence will have its significant role in reducing such manipulations*).

Creative accounting raises, first of all, moral issues (*It needs an ethical debate, it is on the border between innovation and fraud, it is unethical to record income before it is actually realized, regardless the certainty degree*). It uses the existing accounting rules to present the financial situation of a company in a favourable light, without the explicit violation of the regulations in force, but which can raise all ethical issues. Ethics in creative accounting involves finding the balance between innovation allowed by accounting regulations and fundamental ethical principles (*creative accounting involves changing financial information within legal limits, it is apparently legal, but I think it raises at least procedural problems, personal, I believe it is a violation of the ethical principles of the accounting profession, ethical training should be included in professional training programs, a strong ethical conscience can prevent questionable practices that compromise the integrity of reporting*).

From the discussions held, we also identified a number of relevant ethics principles in the case of creative accounting: integrity (*accountants must be honest and present information correctly and completely, respect the true representation principle*), objectivity (*reported information must be free from any type of external influence, which could lead to the reports distortion*), professionalism (*accountants and auditors must comply with the standards in force and avoid any type of behaviour that could affect their professional reputation*), transparency (*all information must be included in the reports clearly, without misleading interested parties*).

Previous studies have presented managers' interests in creative accounting for a variety of reasons. On the one hand, the potential political side of the company to use accounting mistakes but also to manipulate the transaction on the financial markets, to create an artificial image of the companies or to hide a negative impact on a community part.

The companies aim to present rather a permanent tendency to increase the results and managerial performance, so to display fluctuations in the indicators with sudden increases and decreases. Revenue growth can be a creative technique to distract from a number of unfavourable indicators, inducing the false perception of a profitable company by reducing the apparent degree of indebtedness.

A complex combination between relaxed business monitoring, the reward structure of the top management directly linked to the performance indicators, gaps in the legislation, the lack of ethical culture in business leads to a possibility of approaching an opportunistic behaviour on the part of managers that can mislead all other parts: stakeholders, regulatory authorities, shareholders and investors, creditors, employees or the general public. More empirical research has demonstrated the causal relationship between financial frauds and scandals and the lack of ethics, reporting transparency, and the professional attitude of the factors involved.

5. Conclusions

Creative accounting continues to be seen as a flexible use of financial-accounting reporting standards and norms to present a more favourable financial picture of an entity, standing on the border between legal compliance and manipulation of financial information, raising significant ethical issues.

Creative accounting is a practice that involves major risks for both companies and investors, but which can be limited by implementing strict reporting standards, independent audits, ethical education and the use of innovative technologies.

The highly complex and far-reaching phenomenon of creativity in accounting requires standardized educational and regulatory measures to ensure the integrity and transparency of financial reporting.

Creative accounting becomes an ethical issue when it is used with the specific purpose of misleading or manipulating the perception of an organization's financial results and performance. Adherence to ethical principles and the adoption of strict financial reporting standards are essential to maintaining trust in the accounting profession.

The ethics of each one of us leads us to prefer a certain side of accounting: either the technical and scientific side, based on rigor, or the creative side based on art, or the side of stake or social game, thus generating honest accounting policies or biased accounting policies. Although creative, accounting remains an exact science of numbers, and although discrete, its use is widespread.

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