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Management as Cause and Instrument of Creative Accounting Suppression

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The topic of this research refers to creative accounting, the causes of its presence in modern market economy and possible instruments of fight against its further expansion. The problem of creative accounting is mostly dealt with by foreign authors, while a theoretic concept in the Republic of Serbia is still at its early stage. Therefore, in the first part of our paper we will present the reader a notion of creative accounting and the basic methods of its implementation in modern business practice. We will present the results of the research considering basic causes of, according to the opinion of interviewed persons, more and more frequent examples of illicit creative accounting in the composition of financial reports of economic entities in the Republic of Serbia. On the basis of current literature and research results, we will analyse whether auditing is one of the key instruments in fighting a wider implementation of illicit creative accounting.

Key words: illegal creative accounting, management, auditing.

1. Introduction

In the last decade, Republic of Serbia has, as a state in transition, faced the adoption of international standards in the area of accounting and auditing. What emerged as a problem in the implementation of these standards was a multi-decade justification of economic entities management for the use of illegal accounting techniques in composing financial reports. The reasons to justify the application of these processes were: a high inflation rate, severe conditions in market economy, the fact that introduction of market economy was in its initial stage and that the process of transition was still on-going. However, can we really accept the aforementioned reasons in the modern market economy, or do these serve as a front to protect the interests of economic entities management? Therefore, an analysis of the main causes for the use of creative accounting will be the first part of our research, where the following are set as hypotheses:

H1: The basic causes for the use of illegal creative accounting are unethical demands of economic entity management.

On the other side, the quality of financial reports does not depend entirely on those that compose them, but rather on the persons in charge supervision of their regularity. Frauds and intentional presentation of incorrect information are becoming increasingly important in the process of financial reports auditing.

The question is raised: is the process of auditing sufficient to detect a potential illegal creative accounting and up to which degree the options for its possible appearance can be prevented? In accordance to this we will present the second hypothesis:

H2: The basic instrument in suppressing illegal creative accounting is auditing performance with due professional attention.

According to the defined hypotheses we will present the structure of our paper. In its first part we will clarify the notion of creative accounting as well causes of its occurrence. In the second part, we will mention the methods of creative accounting as well as a general attitude of auditors towards its use. In order to explain the basic causes of creative accounting use and suggest possible instruments of its suppression, in the final part we will present the results of the research.

2. Notion and causes of creative accounting

Researching this area we have concluded that accountants and employees in economic entities are generally familiar with the concept of the use of accounting policies to gain economic benefit. However, it is not rarely that this phenomenon is not linked to the term creative accounting. Therefore, in the first part of this paper we will present the notion of creative accounting and causes leading to its use.

There are different definitions of creative accounting, but they all refer to the same or have similar meanings: tax "smoothing", „cosmetic accounting" and financial engineering. This term means the process where accountants are using knowledge of accounting principles to balance positions and their values presented in financial reports. There are other definitions, and we are quoting one of them: „It includes successive selection of accounting methods in financial reporting in a unique way, having the effect of insignificant variations in presented incomes from period to period." [3], p. 101. Common to all these definitions is that creative accounting is used by accountants in order to transform accounting values applying legally permitted accounting selections in evaluation of values and other practices. A majority of authors in the field of accounting and financial reporting perceive creative accounting as a phenomenon which is a routine one and which can be often found in practice, but consider it the activity having a deceptive effect and, generally speaking, an undesirable one.

The authors in this area mostly agree that creative accounting gained in importance by separation of proprietary and management functions in economic entities. The relation between the proprietor and the agent (administrator, manager) is explained by the "agency theory". Namely, it is assumed that both the ordering party and the agent tend to maximize the benefit for themselves. That means that the manager will act in the interest of the owner only when that is his/her interest too (see /6/, p.28). The costs of financial reports composition as well the costs of their auditing could be considered as the costs of agency theory existence, while other costs can also be bonuses paid by owners of economic entities to managers in order to attract them to act in their interest. Also, the goals of economic entity management and employees can be in collision, particularly having in mind the use of illegal creative accounting as an instrument to meet the interests of economic entity management.

In modern market conditions we can find reasons for the presence of creative accounting in the valuation of stocks of open joint stock companies in capital markets and stock exchanges. Economic entities tend to produce a more balanced presentation of results for the accounting period, trying to avoid significant discrepancies and deviations from the expected or usual value of financial results. This can be achieved by the so-called results "smoothing" where an economic entity will capitalize as more as possible costs of assets procurement and compensation of costs related to assets maintenance in years when the financial result is lower than expected. Furthermore, when assessing the value of assets for which the revalorization model is used, the economic entity can select several values among the offered ones, creating „latent reserves" that can be used in the current or following years. This method of creative accounting is particularly used with open joint stock companies since it enables a lower influence of the published financial result on the amount of the stock price for the quoted economic entity. It is well known that the publication of negative financial results or significantly lower ones in the previous accounting period results into a negative stock price fluctuation for this economic entity. Also, this method of creative accounting is particularly appropriate if persons authorized to manage the economic entity consider that publication of a financial result more favourable than the average could influence the stockholders assembly to distribute the earned profit to capital owners in the form of dividends.

The achieved financial result not significantly deviating from planned one is often a demand set before persons authorized to manage the economic entity; by this the management demonstrates its ability to manage and control the financial result. Creative accounting in this case can appear as the application of allowed methods in manipulation of achieved incomes and expenses recognition in a given accounting period. Namely, accounting principles require an allocation of accrual base for accounting to accounting periods when realized, that often opposes to the expectations management and owners of the economic entity can have regarding the results of a certain project or investment. However, the line is thin between the use of this method of creative accounting and an act which is according to the International Auditing Standards defined as a criminal act: „(...) is intentional act committed by one or more persons who are in management positions in auditing client, responsible for management of auditing client, employed by auditing client or by a third person, including also a deception in order to gain unfair or illegal profit" [8], p. 43. Illicit manipulation with recognition of the accrual base of accounting is one of the most common criminal acts in the history of

accounting. We are presenting the example of "Enron" who used this method to illegally present the sale incomes in an amount of over 100 billion dollars [11], p.25. Furthermore, the company „WorldCom“ incorrectly recognized the sale incomes in financial reports in the value of over 958 million dollars [11], p. 7.

The management of an economic entity can use methods of creative accounting also in the case when it wants to indicate to all users of economic entity's financial reports undesirable news or published information. The example is the „K-mart“ company from the United States of America (USA) which presented its financial result as higher by almost 160 million dollars in order to moderate the effect of the information that it was named as the second largest commercial chain in USA [1], p. 8. Hence, we have to have in mind that an experienced investor or stock exchange broker will see through the intention of an economic entity and understand the presentation of improved financial report as a sign of covering its weaknesses. Authors such as Niskanen, Herman and Keloharju indicate that one of the basic motives for the use of creative accounting is also tax payment evasion.

With the Enron collapse in 2001, attention is focused upon the truthfulness and fairness of reporting, depending on whether the mistake in reporting has a fraudulent intention or it is accidental. Today, auditors are obliged to evaluate the effectiveness of economic entity management in prevention of potential frauds. Moreover, auditors should be more proactive in fraud research, i.e. they will have to assess a possibility for illicit actions. Of course, collaboration and communication among all members of the auditing team is necessary. As regards the independence of an auditor, this principle was also redefined after the collapse of Enron when a significant number of services earlier provided by auditors to their clients were forbidden, and changes related to accountability of auditors were also made.

3. Creative accounting methods

Creative accounting can appear even in highly regulated economic systems. International Financial Reporting Standards (IFRS) are considered more rigorous than the American accounting principles (GAAP) regarding the issues of methods selection for the composition of financial reports. Hence, the IFRS give an opportunity to the management of an economic entity to select through accounting policy the method of values assessment for real estates, plants, equipment, real estate investment, nonmaterial investments and financial instruments that will be used: the method of procurement expenditures or the revalorization method. In case of high value assets, the change in the valuation method can significantly impact the financial result of the accounting period, and the economic entity can very simply explain the reasons and justify the change in the valuation method by modern market business where values, particularly values of real estates, are increasing daily. The American accounting principles, composed under a significant influence of the common (precedent) law, leave sufficient space for „creativity“ in the selection of methods, and in certain cases certain economic entities are also allowed to apply methods which are not otherwise allowed [11], p.14. Certain areas of financial reporting are not fully regulated, such as the registry of financial instruments – particularly the options. Actually, all changes in the International Financial Reporting Standards during the last three years are directed to the regulation of recognition, valuation, presentation and publication of financial instruments.

Fictive transactions can be posted in income statement in the current period in order to manipulate values of incomes positions, but can be also used to redirect the profit from one period to another. For example, an asset can be sold to another economic entity and then it can be leased from the very same economic entity. In that case, the sales price can be presented as significantly higher than the purchase one and thereby a positive difference or profit is made. It is believed that fictive transactions are particularly frequent in the states of Europe, while slightly rarer in the American English language zone. In real transactions manipulation can be made to recognize them in an accounting period where it is necessary to achieve certain goals. For example, if the objective is to reveal a less favourable financial result, in current year an economic entity can entirely expend certain assets which are anyway planned to be expended in the next or forthcoming years.

The reclassification or different presentation of assets, capital and liabilities as balance-sheet positions is relatively recently recognized as a method of creative accounting. The International Accounting Standard 1 – Presentation of Financial Reports, underlines that in the income statement the management must distinguish between short-term and long-term assets. One of the basic criteria for such demarcation is also the intention of an economic entity to sell the subject asset or liquidate it in a period shorter or longer than the accounting period. A complicated and maybe impossible task is set before an auditor who must prove that

the economic entity had the intention to sell a certain asset when composing a financial report. On the other hand, the asset is presented in the balance sheet as a short-term asset increasing the value of denominator in the calculation of a general ratio of liquidity.

4. Attitude of auditors towards use of creative accounting

Auditing as a systematic review of financial reports is the key role in the business of economic entities, as well in the functioning of the whole economy. Auditing services have changed rapidly in last tenth years. Auditing goes through a significant development and changes after the globalization phenomenon, as well as after the emergence of the need to harmonize financial reports. Change covers not only application of standards in preparation of financial reports, but also includes a professional dedication of an auditor within the whole process of auditing. At the beginning, the basic function of auditing was an accounting registry at the state level. However, in XVIII century it evolves and gets in importance as a method to detect frauds and misuses within financial accounting. As previously mentioned, that is the period when two functions within an economic entity were created: proprietary and management. The owners of economic entities had a need to control and overview the work of persons authorized to manage. At the beginning of XX century emerges the auditing known to us today as external or "independent" financial reports auditing. The owner of an economic entity or management authority deploys an external auditor whose task is to check whether financial reports are composed in accordance to proper principles and standards, and whether they present the image of this economic entity truthfully and objectively. Having in mind that there is a need and requirement for economic entities to perform auditing once a year, the period of time in which an external auditor has to provide auditing evidence and give his/her opinion is particularly short. Having the previously mentioned in mind, auditors apply certain methods and statistical sampling in order to avoid detailed and comprehensive check of auditing clients' registries. A detailed and full check is performed only in extreme cases, when criminal act is detected or materially significant mistake has been made. Especially if it is a matter of economic entity's property assessment because, according to the International Accounting Standards, hiring of professional assessor of property is not required for the assessment of the property value [6], p. 33.

As mentioned above, auditing should focus on the following: fraud detection, disclosure of technical mistakes and disclosure of non-observance of accounting principles (see [5], p. 7). It is obvious that auditing has gone through several development phases and today it addresses the complexity of information needed by users of financial reports stressing not only their credibility, but creating additional value referring to reporting of irregularities, discovering business risk as well advising management of potential weaknesses of internal control. We can say that the current role of auditing is expanded in relation to the former one, and some changes relate to three main aspects:

- Scope regarding detection of fraud and mistakes;
- Basic characteristics of auditor's independency;
- Accountability of an auditor [4], p. 10.

It is our opinion that the change in the role of an auditor indicates their more proactive role, as well underlines a greater value of reporting itself. With changes and greater expectations of economic entities, the level of relying to financial reports increased too, leading to change in expectations offered by the process of auditing. It implies that auditors themselves must be aware that persons authorized to manage an economic entity can have a motive to use more aggressive methods, and that they have to be more cautious while assessing whether financial reports are presented in a fair manner in such situations. However, the question is raised: up to which degree the regulations and codes of conduct affect the formation of auditors' awareness and their personal ethical principles. Professional accountants' code of conduct is divided in two parts by many authors, where first part should have significant impact to the formation of awareness of fairness and morality of professional auditors and accountants. However, it seems that this is not the case, because the code of conduct rather indicates qualities and characteristics auditing and accounting services must reach than the process of ethics itself. This can be also concluded from the basic objective of auditing, and that is, as we have mentioned, to provide the auditor's opinion whether the financial reports represent a fair image of financial situation in an economic entity, and not to judge whether the reports are composed ethically and nor whether the behaviour of management is ethically correct [7], p. 4. On the contrary, an auditor makes his/her opinion on auditing evidence which must be sufficient and adequate and which is subject to their correctness and truthfulness analysis, while ethics has little impact in this process.

According to our findings, none of the International Auditing Standards, nor Generally Accepted American Auditing Standards deal with the analysis of an auditor regarding ethics of persons authorized to manage an economic entity and a possible reporting of observed examples of non-ethics. It is mentioned that an auditor has to be professionally sceptical about persons authorized to manage, that he/she must not believe their honesty, but it is not mentioned how an auditor should act in the situation when he/she considers persons authorized to manage are not ethically oriented; if it is necessary to withdraw from auditing or to disclose the information in his/her auditing opinion. It can be confirmed that auditors and accountants start the business with an already formed dose of ethics and morality and that a later impact of the profession and regulations have a relevant impact on their "level" of ethics. A justified dilemma imposed against the theory, but also against practice, is: should an auditor be concerned with activities of persons authorized to manage if they infringe only principles and rules of ethics but not the accounting regulations.

5. Research methodology and results

In order to explain whether the economic system in our country justifies the application of creative accounting, a research was conducted at the level of the Republic of Serbia. The research itself lasted during the period May – mid-October 2011. The basic methods of data collection were questionnaires fulfilled by respondents in the mentioned period. The research includes gathering primary data which are considered more relevant than the data from the already conducted researches.

The Software Solution SPSS (Statistical Package for the Social Sciences) as a statistical programme for data processing was used as an instrument of data processing. Employees responding to the survey perform the function of accountants, internal auditors or are members of economic entities management. The research was conducted in 147 economic entities of which 32 responded to questionnaires, that is 21.77% of the total sample. The previously mentioned rate of responses is considered solid for this type of questionnaire. Hence, a great number of economic entities did not want to respond to the survey in spite of insisting, where resistance of polled persons was obvious. However, the submitted survey leave an impression of sincere responses to set questions, and a couple of surveys also contain comments to set questions as additional suggestions of topics to be considered in one of future scientific papers. The research was performed in the largest industrial cities of Serbia.

Table 1. Presentation of economic entities in survey by business activity and geographic location

Activity \ Towns	Towns											
	Belgrade	Novi Sad	Subotica	Valjevo	Priboj	Vrnjaka Banja	Niš	Užice	Pančevo	Šid	Smederevo	Total
Banks	2	1	0	0	0	0	0	0	0	0	0	3
Spare parts shops	0	0	1	0	0	0	0	0	0	0	0	1
Beauty parlours	0	0	1	0	0	1	0	0	0	0	0	2
Public sector	1	0	0	0	0	0	0	0	0	0	0	1
Pharmaceutical industry	1	0	0	0	0	0	0	0	0	0	0	1
Construction industry	1	1	0	0	0	0	0	0	0	0	0	2
Commerce sector	1	2	0	0	0	0	3	0	0	1	2	9
Marketing agencies	2	0	0	0	0	0	0	0	0	0	0	2
Fashion industry	0	0	0	0	1	0	0	0	0	0	0	1
Auditing agencies	2	0	0	0	0	0	0	0	0	0	0	2
Alimentary industry	0	0	0	1	0	0	0	0	0	0	0	1
Insurance companies	1	0	0	0	0	0	0	0	0	0	0	1
Manufacturing industry	1	1	0	0	0	0	0	0	0	0	0	2
Education	1	0	0	0	0	0	0	0	0	0	0	1
Textile industry	0	0	0	0	0	0	0	1	0	0	0	1
Consulting agencies	0	0	0	0	0	0	0	0	1	0	0	1
Oil products and derivatives production	0	0	0	0	0	0	0	0	1	0	0	1
Total	13	5	2	1	1	1	3	1	2	1	2	32

In order to verify the previously defined hypothesis, respondents were asked to list the most frequent ethical causes of creative accounting occurrence in Serbia. The results are presented in Chart 1.

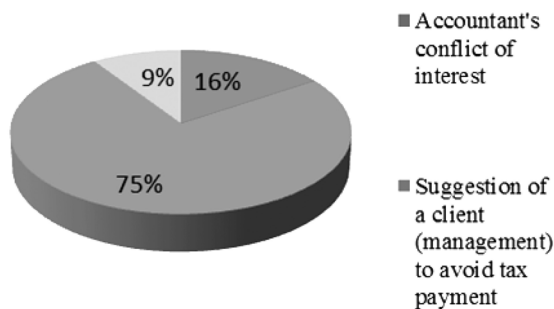


Chart 1: Most frequent causes of creative accounting occurrence in Serbia

We consider it necessary to stress that 27 polled persons, i.e. around 84% of the sample, consider the main cause of creative accounting use to be the impact of economic entity management using it to make certain economic benefit for the economic entity. Out of 15 polled persons performing function of accountants in economic entities, even 13 consider the previous mentioned cause the most frequent one in practice.

Chart 2 presents the results of the respondents' answers to the question of whether they think that creative accounting is an increasingly present phenomenon in modern business.

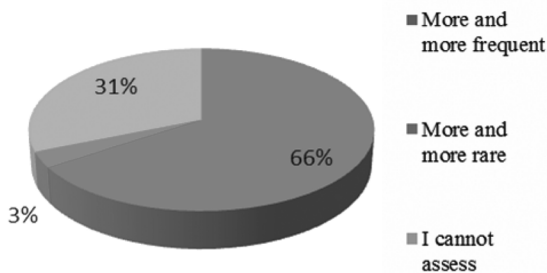


Chart 2: Frequency of creative accounting occurrence in practice

It can be concluded from the above presented chart that the majority of polled persons consider the application of creative accounting increasingly frequent in practice which stresses the significance of illegal creative accounting as a problem in the accounting profession. Having this in mind, we thought it would be important to get the opinion of respondents on the possibilities of creative accounting full suppression in practice. The results are presented in the following chart.

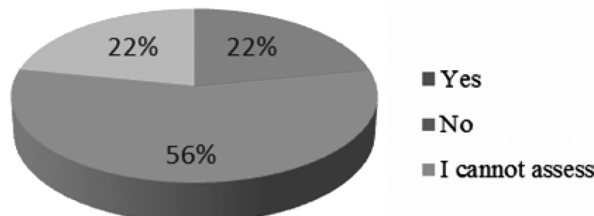


Chart 3: Is creative accounting a problem that can be fully eliminated?

The previously presented results indicate that it is once again confirmed that application of creative accounting is present in business of economic entities in the Republic of Serbia to a significant degree and that most of the respondents included in the conducted research deem that it cannot be fully eliminated in practice. Hence, it is obvious that the application of adequate instruments can decrease its widespread use. The respondents were asked which instruments, according to their opinion, have a most effective impact.

As we have previously indicated, the quality of financial reports mostly depends on the quality of performed auditing, because this gives attestation of correctness to the composed reports.

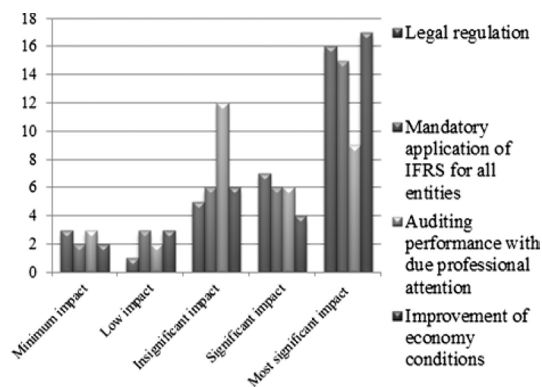


Chart 4: Impact importance of certain instruments in suppression of creative accounting

Hence, the results show to the contrary; the respondents think that auditing performance with due professional attention as an instrument of fight against illegal creative accounting has a negligible or insignificant impact. The improvement of economy conditions is considered the best instrument to be used leading to the conclusion that polled persons think that the use of illegal accounting is the consequence of bad economic entity's business conditions. Having in mind that the final result of illegal creative accounting use is the economic benefit, it is logical to think that the need for illegal creative accounting would disappear if economic welfare existed. The second in view of the importance of impact are accounting regulations, i.e. the legal stipulation and mandatory application of the International Financial Reporting Standards.

Conclusion

We cannot but conclude on the basis of the results of the research that creative accounting is a phenomenon present in companies to a significant extent. Hence this is the area of accounting rarely mentioned in domestic literature. We notice that our respondents, although daily facing illegal application of accounting methods to achieve certain economic goals, do not recognize this phenomenon as illegal creative accounting. The results of the conducted research verify that most often the cause of illegal accounting application is the demand of the economic entity management to earn economic benefits. It can be concluded from the previously stated that accountants are probably in an unenviable situation and therefore they see application of illicit creative accounting methods as a daily obligation to execute the orders of the economic entity management. It seems that employees in accounting or auditing agencies do not consider the use of illegal accounting as breach of ethical accounting demands, but the way of certain economic entities' business. During the research, considering the respondents as owners of private accounting agencies, we came to the conclusion that they suppose that they will not be employed again if they do not meet the client's expectations considering the disclosure of financial results. We believe that the previously presented problem has to be solved by an additional education of economic entities' owners on the goal of accounting and auditing of financial reports. The second hypothesis in our paper was not verified by the research results, because financial reports auditing with due professional attention is considered by our respondents an instrument which insignificantly impacts the suppression of illegal creative accounting. The improvement of economic conditions and legal regulation of this area of accounting has the most significant impact in the opinion of the respondents. Hence, after the analysis of amendments of the Law on Accounting and Auditing currently effective it was noticed that insufficient attention was paid to the regulation of illicit use of accounting methods for the purpose of economic benefit gaining, and therefore no significant improvement for legal regulation of illegal accounting use can be expected. On the other hand, having in mind that the Republic of Serbia is in the process of transition, currently in negotiations on the status of a candidate for a full membership in the European Union, and that public generally expect improvements in the economic conditions in the forthcoming period, we presume that the need for implementation of illegal creative accounting in daily business will decrease.

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