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Creative Reporting: An Overview

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One of the important causes that can be traced to have some understanding of the potential financial reporting gap and as well as the inconclusiveness of accounting numbers is the use of creative accounting (deceptive accounting as used by Joseph Stiglitz, Nobel Winner in Economics) by the management to have their position secured by serving the finance providers through abuses of accounting principles and manipulation. It is striking that the creative accounting issue ranks above tax evasion as an ethical issue for Australian practitioners[1]. Four authors in the UK, everyone writing from a different perspective have explored the issue of creative accounting: Ian Griffiths, writing from the perspective of a business journalist, observes: "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. It is the biggest con trick since the Trojan horse … In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting" [2].

Michael Jameson, writing from the perspective of an accountant, argues: "The accounting process consists of dealing with many matters of judgement and of resolving conflicts between competing approaches to the presentation of the results of financial events and transactions … this flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities – practiced by the less scrupulous elements of the accounting profession – have come to be known as 'creative accounting'[3]. Terry Smith reports on his experience as an investment analysis: "We felt that much of the apparent growth in profits which had occurred in the 1980s was the result of accounting sleight of hand rather than genuine economic growth, and we set out to expose the main techniques involved, and to give live examples of companies using those techniques[4]. Kamal Naser, presenting an academic view, offers this definition: "Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them[5].

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It is interesting to observe that Naser perceives the accounting system in Anglo-Saxon countries as particularly prone to such manipulation because of the freedom of choice it permits. However, two basic features are common to all experts:

- They perceive the incidence of creative accounting to be common.
- They see creative accounting as a deceitful and undesirable practice.

Creative accounting can be located in the areas like income smoothing, manipulating profit to tie up with forecast figures, avoidance of bad news, reduction of risk and delaying release of information in case of insider trading etc. Revsine[6] offers a discussion of the 'selective financial misrepresentation hypothesis' that can be seen as offering some defence for the practice of creative accounting drawing heavily on the literature on agency theory and positive accounting theory. He considers the problem in relation to both managers and shareholders and argues that each can draw benefits from loose accounting standards that provide managers with latitude in timing the reporting of income. It discusses the benefits to managers in being able to manipulate income between years so as to maximize their bonus entitlements and he argued that "it is reasonable to presume that those who negotiate managers' employment contracts anticipate such opportunistic behaviour and reduce the compensation package accordingly … since they (managers) have already been charged for the opportunistic actions they must now engage in them in order to achieve the benefits they 'paid'for"[7].Shareholders also benefit from the fact that managers can manipulate reported earnings to 'smooth' income since this may decrease the apparent volatility of earnings and so increase the value of their shares. Other management action, such as avoiding default on loan agreements, can also benefit shareholders. So, Ravine's analysis focuses the implicit views that the prime role of accounting is as a mechanism for monitoring contracts between managers and finance providers which we would argue that if it becomes the fact behind the scene then it will be a great injustice to the other users including the larger society.

The creative accounting is severely criticized by the Blue Ribbon Committee[8] and they considered that "some companies do respond to analysts and short term market pressures by managing their earnings". The report further continued as "whilst earnings management is not necessarily inappropriate, it can become abusive when it obscures the true financial performance of the company". The committee highlighted various earnings management practices:

- Deliberately overstating one time "big bath" restructuring charges in order to provide a cushion to satisfy future ……… (Stock market) earnings estimate.
- Misuse of acquisition accounting with improper write offs so as to overstate future earnings

- Over accruals in good times in order to smooth out future earnings in bad times
- Premature revenue recognition
- Improper deferral of expenses to improve reported results
- Misuse of the concept of materiality to mask inappropriate accounting treatments

Another factor that could induce management to smooth companies' reported earnings are the existence of a bonus plan. Watts & Zimmerman[9] reported that "ceteris paribus, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to current period" what we have already discussed while discussing Ravine's analysis of creative accounting.

So, in the litigious climate of the contemporary business world it is important that careful consideration be given to the implications of what is being stated. An emphasis in decision orientation to term the financial statements 'useful', no doubt, enhances the status of the discipline. As such, this may be an interesting theoretical approach; however, the implementation based on such ideas may be tough and hence, lead to methodological problems in exploring a holistic view of the matter in question. And we would argue that the decision making focus of accounting output is another element in the financial statement expectations gap.

Besides that, the audit profession did not offer any suggestion that the financial statements were fit for decision making as part of their message. Zeff reported that "most auditors had probably been educated to believe that accounting serves primarily a stewardship function, and that they would find it somewhat threatening to contemplate that accounting should have a more activist function in economic society. Such preconceptions and predispositions made it difficult for the board (FASB) to impose a decision usefulness objective on a profession that had been accustomed to view accounting as basically a passive record keeping activity"[10].

Furthermore, it can also be viewed that auditors know more about the financial statements than all the other users or other sections of the society. Therefore, when the message contained in the audit report does not seem to include decision-making aspect, how the users will take it seriously.

The questioning of the rationality in using historical cost in financial accounting is not a new phenomenon. "Many accountants have deserted the historical cost camp upon hearing a persuasive argument that historical cost is irrelevant to economic decisions. Relevance to decisions is considered to be the primary requirement of

accounting information, and hence irrelevance to decisions appears to be the most fatal weakness of historical cost”[11].

The weaknesses of historical cost accounting have also been supported by the Committee on Accounting and Auditing Measurement of AAA[12]. The committee considered that “conceptually the superiority of financial reports based on current values is so self-evident, at least on the relevance dimension, that we cannot defend the maintenance of historical cost as the primary basis of management”[13]. The above is the majority view of a six-member team of AAA. However, the minority suggestion came in the way: “… those advocating current values for input assets would need to put forward persuasive evidence that such values are representative of value in use – that is, that there is good cause to believe that changes in input values will lead to corresponding changes in output values[14].

It may be thought that historical cost is more objective than any other valuation basis, but as Sterling[15] points out that “most writers outside the field of accounting consider that the word ‘cost’ closes the discussion of objectivity. Nothing could be further from the truth”. There are subjective assessments even with historical costs – but the whole notion of splitting the life of the business into artificial periods is subjective, and it is valid to question what the figures mean. However, the idea that a quick fix can be supplied by using alternative accounting bases (current costs, replacement cost or current values etc) is problematic, because there would still be the question as to what the adjusted figures were supposed to mean.

In the context of using alternative values other than historical cost Mattesich[16] stated that “This information is useless if accountants, financial analysts, and other users of financial statements are insufficiently trained and can not properly interpret this kind of information”. Indeed, this may be the primary reason why Beaver & Landsman (1983)[17], in studying the reaction of statement users, came to the surprising conclusion that financial statements based merely on historical cost are at least as informative, or even more so, than those using current values or any other kind of price level adjustment.

It is therefore, valid to question whether adjustments from historical cost to any other valuation basis would have a material impact on the financial statements or they may just give them the appearance of artificial precision and this could be part of the financial statements expectation gap. Perhaps we should remember: “If accounts are found to be untruths anyhow ……… there is much to be said for the simple untruth as against a complicated untruth, for if the untruth is simple; it seems to me that we have a fair chance of knowing what kind of untruth it is. A known untruth is much better than a lie and provided that the accounting rituals are well known and understood accounting may be untrue but it is not lies; it does not

deceive because we know that it does not tell the truth, and we are able to make our own adjustment in each individual case, using the results of the accountant as evidence rather than as definitive information"[18].

To go further, in terms of decision-making, even current values may be irrelevant. If current values were used and the associated unrealized gain was shown in the accounts, what would happen if there was a collapse in the current value after someone had taken a decision based on these data? On the other, if the unrealized gains are not shown in the financial statements it will be argued that users may take the wrong decision. So, accountants cannot win. Therefore, may be users should be discouraged from taking decisions based on the financial statements irrespective of whether historical cost or current values are used.

At this juncture, we can argue that many of the problems associated with financial reporting stem from the specification of the objective of accounting and reporting and its associate postulates. The use of theory taken up from economics, in which the prediction of the future tends to be a matter of course, may not have helped the situation. And practically there lies the difference. When economists predict, almost all takes it for granted that it is a prediction (for example, five year plans) but when accountants go for a prediction, everyone assumes that it is near accurate.

Since 1970s onwards, more importance has been attached to the incorporation of future cash flows into the financial statements[19]. Chambers considered that "it is notorious that those who attempt to quantify future magnitudes may obtain vastly different results, as well as results which differ materially from what the magnitude turns out in due course to be"[20]. This refers to the problem in terms of reliability of the data and its audit. So, in reference to a dynamic & volatile business environment, the prediction of future cash flows based on the financial statements may be part of the financial statements expectation gap.

To be useful to users, accounting data must have the character of reliability. To be reliable, the data that will be presented in the accounting reports must be neutral, i.e., free from bias[21]. But, are the financial statements free from bias? Or is it the auditors that ultimately clear up the biases or at least minimize it? It is the subjective nature of accounting estimates and ulterior management motivations, hidden by the complexities of modern business structure that make bias difficult to detect. Reported profit is a function, not only of the economic activities of the firm but also to a great extent of the accounting estimates made by management.

It is important to note that the auditor's report says nothing about economy, efficiency and effectiveness. And if the auditor says nothing about all these, how are the users expected to form their own opinions? This is very much at par with the Lee

& Tweedie's empirical evidence[22] regarding users lack of comprehension of some fundamental axioms of accounting.

Conclusion

In this paper we have tried to concentrate on identifying some of the potential elements of the expectations gap in regard to the reporting function of accounting. It is evident that central to this has been the emphasis of the conceptual framework setters on the decision usefulness of the accounting reports. The discussion made has suggested that a misinterpretation of the usefulness and limitations of the financial statements appear to have resulted in a financial statements expectation gap. Instead of a claim that the financial statements are "all things to all people", a greater recognition of the limitations of the financial statements is required to tackle the financial statements expectation gap. Only the recognition of these limitations and the clearer specification of the overall problem will enable the commencement of the real debate regarding corporate communication of perfect and reliable information to the legitimate stakeholders.

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