

## Exploring the Nexus of Creative Accounting on the Reliability and Objectivity of Financial Reporting: A Concept Paper

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### Abstract

Creative accounting involves the strategic manipulation of financial statement data by accounting experts. While financial statements are expected to represent a company's performance faithfully, creative accounting has become integral to financial reporting. However, its association with the extent of managerial involvement raises concerns about the accuracy of financial data. This conceptual study aims to dissect the driving components behind adopting creative accounting practices and their profound influence on the credibility of financial reporting. The investigation encompasses critical areas, including corporate governance, agency conflicts, ethical considerations, and a company's future orientation. The findings illuminate that the utilisation of inventive accounting methods by management significantly and unfavourably tarnishes the reliability of financial reporting. Notably, statutory auditors emerge as pivotal figures capable of nurturing creative accounting practices that, when guided ethically, can positively enhance the precision of financial reporting.

**Keywords:** Creative Accounting, Reliability, Financial Reporting, Accounting Manipulation, Agency Problems.

### **Introduction**

In today's financial landscape, marked by a growing demand for transparency and trust, this study is born out of an urgent need to probe into the complex world of creative accounting and its profound implications for the reliability and objectivity of financial reporting. Past corporate scandals, such as those involving Enron and WorldCom, serve as unambiguous reminders of the devastation that unethical financial practices can wreak upon companies and their stakeholders. With these lessons in mind, our research embarks on a journey to dissect the factors that drive creative accounting and, in doing so, provide invaluable insights into safeguarding the integrity of financial reporting. Occurred economic failures have raised doubts regarding the integrity of accounting as an authentication practice and the accuracy of accounting reporting (Liberto, 2022). Creative accounting means a managerial decision that impacts reported income but offers no genuine economic benefit to the firm and might even have long-term adverse effects (Akpanuko & Umoren, 2018). In addition, the organisation might modify the results shown in the accounting records while still following every applicable accounting rule and other laws by using a variety of creative accounting approaches. Managers can apply creative accounting by using various accounting policies, poor judgment, fictitious transactions, and timeliness of actual business transactions. Examples of creative accounting techniques that managers usually implement include window dressing, capitalising expenses, contingent liabilities, adopting different accounting policies, and many more (Mokhlis, 2019). Furthermore, considering how firmly embedded the creative accounting techniques are, including those with the most favour, several practitioners are completely sceptical regarding finding a remedy to such manipulations. Hence, it is essential to determine how much this ingenuity undermines financial reporting because the accuracy of the disclosed financial reporting is essential for the investors in the company to ensure the right decision is made.

### **Background of the study**

An article relating to the effect of creative accounting on the reliability of financial reporting in Pakistan by Shahid and Ali (2016) explains the factors that led to creative accounting practices. The article explains why company agents are urged to manipulate firm accounting to look good in the eyes of its shareholders and gain benefits such as shareholders continuously investing in the company. However, it was all made up of creative accounting techniques. In addition to determining the connection between creative accounting practices and dependability accounting reporting, this study will attempt to investigate the impact of creative accounting factors such as agency problems, top management and corporate governance, company ethical values, and company future orientation on the reliability of accounting reporting (Shahid & Ali, 2016).

This study also seeks information through other articles, which detail the impact of creative accounting on financial statements in the Middle East and a few more articles. The supplementary and supporting articles are all precisely related to the content of the main reference and help this concept paper to study creative accounting's implications, and at the same time, also provide more detailed and additional information. For example, this article elaborates on the techniques of creative accounting in four categories, explains the implications of creative accounting on accounting reports, and describes more about the manipulation and scandals made by the most prominent companies that happened in the 1990s.

The research paper on the implication of creative accounting is essential to understand that the laws and regulations, neither International Financial Reporting Standards (IFRS) nor Generally Accepted Accounting Principles (GAAP), have stated that creative accounting practices violated them. It is somewhat not opposed to the law. However, it can result in fraud, just like the Enron scandal. Many firms want their financial statements to be reliable and have realistic results, yet the performance must be pleasing to the shareholders. Most of the time, creative accounting is used to exploit businesses' weaknesses to make a business's financial performance look more attractive than it was. The primary focus of creative accounting is consciously altering statements to satisfy the company's stakeholders.

The potential users of this research paper are managers of companies, shareholders, accountants, auditors, stakeholders of business companies, users of financial reports and others. This concept paper can help them learn more and identify the possible factors that can lead to creative accounting for manipulation. Hopefully, the findings will benefit all users for their additional knowledge.

### **Problem Statement**

It is essential that financial statements accurately reflect the financial status of companies. These statements are utilised as a basis for decision-making by stakeholders. Accountants occasionally employ creative accounting strategies to affect accounting results in financial statements (Mokhlis, 2019). However, to suit management demands on the firm's performance, some people may improperly utilise creative accounting procedures in preparing financial statements, resulting in the financial statements being deceptive. The pervasive corruption in society and the failure of organisations in every region of the world have once again heightened the necessity for accounting professionals to adhere closely to rules of professional behaviour. This corruption has increased the scrutiny of the accountant's job from inside and beyond the profession (Ismael, 2017). Suppose professional accountants overly do creative accounting. In that case, the reliability of financial reporting is concerning since the figures shown in the financial statements are modified and fictitious, which is harmful to the managers and shareholders making future decisions. Deliberately, imagine if the actual figure of the company's revenue is at a loss and its future is at a concerning level. In that case, it can lead to company bankruptcy, and the shareholders are deceived and waste vast amounts of money since some may invest a large amount of money into the company. They think the manipulated figures are actual and can give them stable investment returns. Furthermore, the financial statements are modified creatively by accountants. They inflated asset value, enormous inventory, cut expenditures, changed depreciation methods, and many more. Their business may be profitable in the short term. However, after their deed is exposed, the business will suffer long-term losses like share price decline, bankruptcy, and insolvency. Enron and WorldCom are famous examples of creative accounting. Therefore, it can be said that creative accounting techniques are caused mainly by corporate governance, management engagement, ethical ideals, perspective with additional factor understanding of accounting rules, and manipulative behaviour by owners and management (Shahid & Ali, 2016).

### **Literature Review**

It is important to identify what factors impact financial report from the application of creative accounting. Thus, the factors that will be examined in this study are how corporate governance, agency problems, company ethics, and future orientation lead to implementing

creative accounting practices and how creative accounting affects the reliability and objectivity of financial reporting.

### **Factors That Encourage the Implementation of Creative Accounting Practises**

#### **Corporate Governance**

Corporate governance or top management is responsible for enforcing rules and regulations, making decisions, and monitoring the performance of management. Corporate governance may limit creative accounting techniques since it functions as an eye. A firm can expand its number of outside directors; its social responsibility would grow since it will be liable to more people (Ismael, 2017). Moreover, the functioning of corporate governance depends on the organisation's form, its directors' involvement, and its management. Therefore, the well-designed structure of audit disapproves of creative accounting procedures. Meanwhile, business directors engage in unethical, creative accounting procedures (Shahid & Ali, 2016). Consequently, all directors, management, and business structures collectively shape corporate governance. If the directors frequently perform well-defined internal audits, this can lead to the regulation of creative accounting procedures. Lastly, it has revealed that independent director involvement might help to prevent creative accounting techniques.

#### **Agency Problems**

A study has referred to several related studies about the influence of agency problems towards creative accounting and the credibility of financial statements. The main cause of agency problems is managers prioritising their self-interest instead of the principal's. Furthermore, this can lead to a predicament as managers who try to use their power for their benefit tend to use creative accounting. Consequently, creative accounting is influenced by the agency problem. In addition, the managers will manipulate financial statements for their benefit when problems arise between the principal and managers. Lastly, to minimise their profit payment in taxes and dividends, managers will use creative accounting to make statements that look good so they can get rewarded. This ensures they can maximise their salaries, bonuses, and other perks (Shahid & Ali, 2016).

#### **Company's Ethics**

Business ethics distinguish between ethical and unethical behaviour in the context of a company's management. When it comes to deciding whether or not to adopt creative accounting practices, the ethical judgments upheld by a company play a significant part. Investors cannot recognise fabrications in accounting records, and deceiving investors is not a practice that can be considered justifiable. The study results show that management's use of creative accounting as a tool depends on the company's ethical culture. A company will surely suffer long-term losses and losses in goodwill if it has inadequate ethical standards that enable creative accounting techniques. Therefore, manipulating financial statements on purpose to mislead investors is a practice that falls far beyond the limits of ethical behaviour. Financial reporting does influence managerial and investment decision-making. They also claim that there must be high levels of transparency to avoid corporate fraud. Furthermore, a favourable relationship between the firm's ethical standards and dishonest behaviour (Shahid & Ali, 2016).

**Company's Future Orientation**

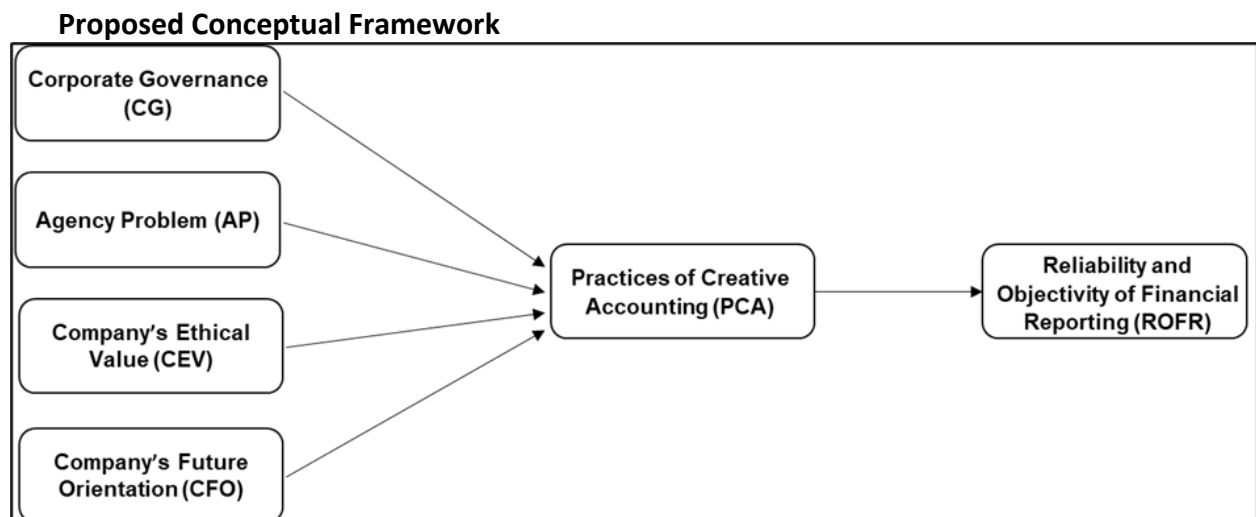
When final reports are altered, the business reputation is at risk, and the owner seeks immediate benefit rather than bearing the significant long-term costs of fraud scandals. It implies that a company's focus on accomplishing short-term goals or obtaining long-term benefits is another motivation for using creative accounting methods. A company that adopts flexible accounting or reporting requirements might utilise creative accounting in a crisis. The study also details financial reporting macro manipulation and how it affects a company's stock price and capital market. It also ultimately raised the investor's risk, which increased the possibility of loss. Creative accounting significantly affects the qualitative features of financial reports specified by IASB, including understanding, relevance, reliability, objectivity, and comparability. While the frequent use of creative accounting by management raises concerns about the veracity and impartiality of financial reports, it significantly impacts financial reporting (Shahid & Ali, 2016).

**Implication of Creative Accounting on Financial Reporting**

Alternatives based on appreciation and choice enable management enterprises to translate legal, economic, and financial solutions for problems that guidelines alone cannot resolve. This leads to subjectivism and creative accounting, which alter the outcomes and information in financial statements. Additionally, creative accounting enhances and supports a company's reputation and carefully chooses the facts to keep readers interested (Mokhlis, 2019).

Furthermore, creative accounting techniques impact the four primary financial statements. If managers get creative with and change the amount on the balance sheets for its assets or liabilities, creative accounting practices directly affect the list of financial positions. In order to optimise revenue by lowering present expenditures, a particular method entails deferring current period spending to succeeding periods. It also brings up the income statement, where creative accounting techniques directly affect it by emphasising sales, cost of goods sold, and total and net profit. The income statement depicts the organisation's profits, expenses, and net profits or losses over a specific time period. Any manipulation of the income statement figures has a negative effect on the Statement of Equity Changes. The reason is that the equity statement depends on net earnings from the income statement. Last but not least, it is noted that the cash flow statement is affected directly and visibly by creative accounting techniques because they show inaccurate cash flows into and out of organisations. Creative accounting methods emphasise investment and financial flows less and more on operating cash flows (Aletaiwi, 2022).

The accountants' objectivity and integrity significantly impact the financial reporting's credibility and quality. A company's financial report should adhere to the objectivity rules, which require all professional accountants to uphold their professional standards and refrain from letting outside pressure, hidden agendas, or their own biases affect their judgment in company decisions (Lukman & Irisha, 2020). If the accountants and auditors fail to perform their task of preparing the financial reporting truthfully, it will negatively affect the quality and reliability of the financial reporting, which will make the company stakeholders develop doubtful feelings and scepticism towards the company. Other than not gaining trust and losing financial reporting reliability from the shareholders and investors, the worst scenarios may involve legal actions such as fraud charges against the company. Hence, good financial reporting is trustworthy and will not confuse readers when they assess corporate productivity and performance, formulate planning, or generate ideas and decisions.



**Figure 1:** The Proposed Conceptual Framework for Factors that Influence Creative Accounting Practices and Its Impact towards Reliability and Objectivity of Financial Reporting

Figure 1 shows the variables that drive businesses in Pakistan to adopt creative accounting practices. It addressed variables such as corporate governance, the agency problem, the company's ethical value, and the company's future orientation, all of which impact the financial reporting's reliability and objectivity.

### Recommendations

Creative accounting is an accounting practice that depicts a company's financial status as better or worse than it is. While the tactics are technically lawful and do not break GAAP, they are ethically dubious.

The consequences of disclosing creative accounting practices, which some consider fraud, can destroy a company's reputation and is a persuasive reason to avoid it. The manipulation of the financial statement figures can be prevented if only creative accounting is avoided. Therefore, an internal supervision and control record is their responsibility and should be divided among the organisation's accountants to eliminate creative accounting that can lead to manipulations. It has been mentioned that organisational shareholders should guarantee that competent and inventive managers and staff members are engaged in companies to ensure the effective use of resources in creating profit for the firm, as this will assure continuing trustworthiness on financial reports presented (Adediran et al., 2013). In addition, more minor organisation mergers should be encouraged and initiated by regulatory bodies. This will boost the trust in their report and may lead to more investment, encouraging the nation's economic growth. An individual fraudster's likelihood will decrease when more tasks are separated. The connection is seen between elements of clarity and disclosure of information, as well as the level of impact for creative accounting drivers.

Following that, an unbiased audit committee with comprehensive audit competence that engages with external auditors in person is required. Since audit standards of quality are influenced by an auditor's ethical value when reviewing accounting data, such as financial statements, ethics are considered vital in auditing. Furthermore, auditors' capability to recognise creative accounting techniques' independence, integrity, objectivity, contingent charges, advertisement rights, commission computation, and organisational structure all have a massive impact. As a result, professional bodies should work to ensure that their



members in practice are adequately controlled in performing their audit tasks. This would assist in reestablishing the trustworthiness of financial accounts examined by multiple audit companies (Adediran et al., 2013).

Lastly, the organisation's shareholders must diversify their investment holdings to prevent issues created by some corrupted companies' creative accounting (Aletaiwi, 2022). Accounting regulators want to minimise creative accounting by limiting the number of accounting procedures used or by specifying the conditions in which each method should be used. The most current International Accounting Standards (IAS) developments aim to minimise accounting alternatives. Adherence to these rules will help policymakers and regulators check managers' abuses. As a result, better annual report readability is related to lower intellectual capital efficiency for businesses in the finance industry, and corporate governance methods such as diversified investment holdings along with the size of the audit committee also produce annual reports that are simple to understand and complement agency theory (Jarrah et al., 2022).

### **Conclusion**

In conclusion, this study substantially contributes to financial reporting and corporate governance. By meticulously exploring the intricate relationship between creative accounting and the reliability of financial reporting, we have armed corporate leaders, auditors, and regulators with a deeper understanding of the challenges and opportunities within the economic landscape. Our findings shed light on the motivations driving creative accounting practices and offer concrete recommendations for mitigating their adverse effects. Furthermore, this research bridges academic inquiry and real-world application, offering actionable insights to managers, shareholders, accountants, and auditors on how to detect, prevent, and combat creative accounting practices. By comprehending the ethical and governance factors that underpin these practices, stakeholders can make informed decisions, fostering a culture of transparency and trust in the corporate world. In an ever-evolving financial landscape, where accountability is paramount, this study serves as a guiding light, directing us toward ethical financial reporting. It ensures that financial data remains a reliable compass for all stakeholders. We hope that the knowledge gleaned from this research will empower individuals and organisations to navigate the complex terrain of finance with integrity and confidence.

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