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Characteristics of creative accounting: A Multifaceted Literature Analysis

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Abstract

Creative accounting has become a widespread practice in financial reporting. It involves manipulating financial data to paint a more positive picture of a company's financial performance or position. This paper aims to provide a comprehensive exploration of creative accounting. It will delve into its underlying factors, characteristics, different forms, and associated Implications. By reviewing existing literature, we will examine the complex relationship between creative accounting and factors such as ethics, quality of disclosure, internal control, and ownership structure. The discussion will shed light on the double-edged nature of creative accounting, acknowledging its potential for innovation in accounting practices while also recognizing its negative consequences for stakeholders when used unethically. Various forms of creative accounting, including earnings management, income smoothing, and big bath accounting, will be examined in detail, with a focus on their impact on financial reporting transparency and stakeholder perceptions. Additionally, this paper will discuss the precautions associated with creative accounting, emphasizing the need for careful consideration in financial decision-making and the importance of regulatory frameworks and ethical conduct. Finally, the paper will conclude by identifying areas for further research and discussing potential strategies to mitigate the risks associated with creative accounting practices. Overall, this paper aims to enhance our understanding of creative accounting and its implications for financial reporting and decision-making processes.

Keywords: Creative Accounting; Income smoothing; Earnings Management; Aggressive accounting

1. Introduction

The emergence of creative accounting as a contemporary phenomenon in the 21st century, particularly gaining traction post-economic crises, is aimed at manipulating financial metrics within the legal framework to project desired financial standings. This practice exerts influence on stakeholders' perceptions and has the potential to distort accurate financial data through the exploitation or ignorance of rules. Creative accounting is intricately linked with financial reporting and information technology due to the prevalent practice of presenting financial data in a manner that portrays a more positive outlook compared to its truthful representation (Abed et al., 2022). Creative accounting, a term used to describe the practice of manipulating financial data or transactions to present a more favourable view of a company's financial performance or position, encompasses various techniques, such as utilizing accounting methods, exploiting loopholes, or exercising discretion to boost profits, decrease expenses, inflate assets, or mitigate liabilities (Gupta & Kumar, 2020). It involves the manipulation of financial information within the confines of the law to showcase a specific financial standing, as highlighted by Floştoiu (2022). This phenomenon encompasses the utilization of accounting expertise to impact financial indicators without directly contravening accounting regulations, as discussed by Shevchenko and Liadska (2015). The ramifications of such manipulation extend to altering the attributes of accounting information, influencing investment decisions of users, and challenging the credibility of accounting professionals, as noted by Adeosun et al. (2021). The core essence of creative accounting lies in the quest for innovative problem-solving approaches, embellishing financial statements, and crafting a favourable entity image, even if it strays from the genuine financial depiction (Abed et al., 2022). While creative accounting may serve as a recourse to rescue a business from

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collapse in specific scenarios, it blurs the distinction between legitimate options and deceitful financial reporting practices (Cugova & Cug, 2020). Ultimately, the application of creative accounting should be grounded in professionalism, ethical considerations, and the imperative of upholding integrity in financial reporting.

Abed et al. (2022) conducted a comprehensive analysis of its impact on financial reporting quality, with a particular focus on the banking sector. The study findings reveal a correlation between the influence of creative accounting determinants and the levels of transparency and disclosure. Moreover, the research underscores the adaptability of these determinants, hinting at implications for transparency, disclosure, and the quality of financial reporting. According to Cernusca et al., (2016), it is apparent from surveys conducted that the majority of accounting students do not exhibit a proclivity towards employing creative accounting techniques to optimize tax outcomes within legal boundaries. Conversely, more than half of the surveyed accounting professional's express openness to considering such practices while adhering to regulations to enhance tax optimization. While creative accounting may carry negative implications if it distorts the accurate financial status and performance metrics, it remains a pivotal element in shaping accounting policies. Nevertheless, the potential advantages of creative accounting should not be disregarded, as they hinge on the professional discernment of accountants and the ethical conduct of managers (Cernusca et al., 2016).

This study aims to map out the various scholarly inquiries conducted mainly by researchers from developing nations regarding the characteristics of creative accounting, in order to create a comprehensive overview of the research landscape in this area. As a result of the research endeavor, several unexplored areas of inquiry in this field will be raised, which have not yet been investigated by scholars. Our study aims to identify the key factors that indicate creative accounting practices to determine the potential usefulness of these early warning signals in predicting or detecting future financial misrepresentation.

2. Process and Research Method

The researchers have diligently carried out a comprehensive systematic review and bibliometric investigation, ensuring a strong and reliable foundation by meticulously adhering to four essential and progressive stages: searching, evaluating, synthesizing, and scrutinizing relevant previously published research. Throughout the process of identifying pertinent literature, a wide array of filters and criteria were implemented at different stages, contributing to a thorough examination of the subject matter. The researcher meticulously observed the interconnectedness of the research papers of interest and the findings are visually represented in Figure 1 displayed in the research report.

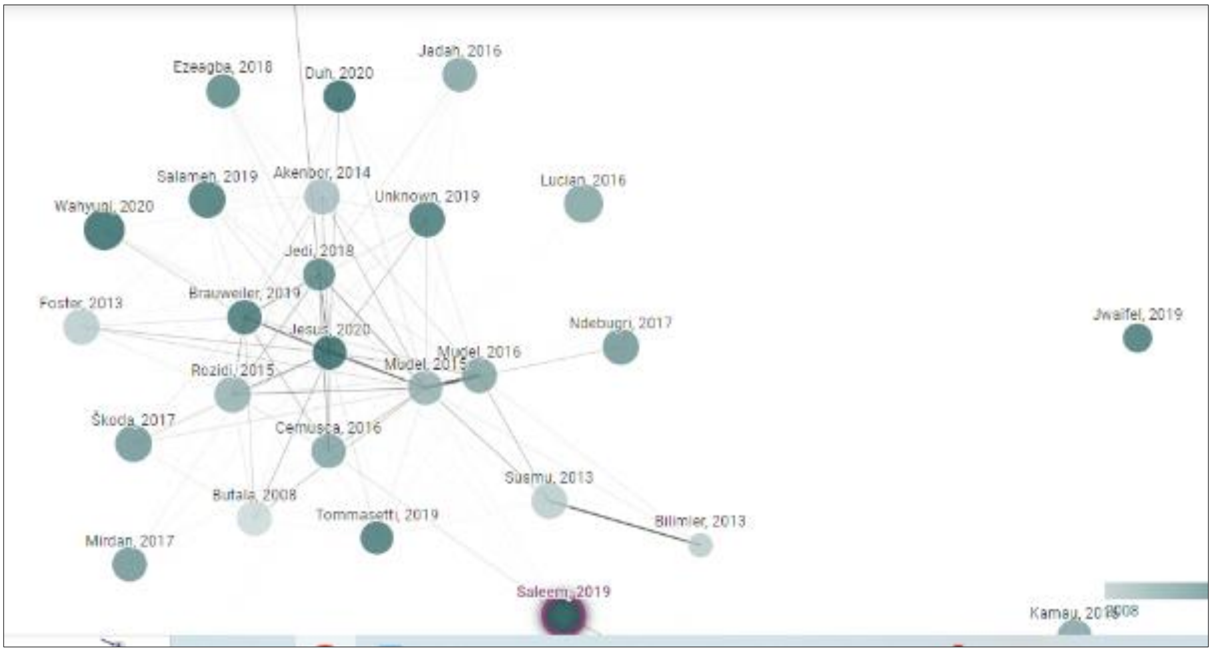

Figure 1 Interconnectedness of Reviewed papers

The interconnectedness of the various studies reviewed is visually depicted in Figure 1 below, showcasing the comprehensive analysis conducted by the researcher. All studies captured within the network were taken into consideration and thoroughly examined to ensure a comprehensive understanding of the topic at hand.

3. Literature review

Creative accounting is influenced by four fundamental determinants: ethical issues, disclosure quality, internal control, and ownership structure (Škoda et al., 2017). Administrators have the ability to selectively manipulate accounting aspects to enhance the perceived attractiveness of businesses, projecting improved profits and financial stability. However, this can sometimes mislead users and investors, hindering corporate growth and investment mobilization (Farhan Jedi & Nayan, 2018; Kamau et al., 2015).

The phenomenon of creative accounting is subject to both positive and negative perspectives. Positive aspects encompass the innovation of accounting principles and techniques, while negative aspects involve unethical practices aimed at attracting stakeholders (Mudel, 2016). Wahyuni et al. (2020) underscores the significance of accounting standards in enhancing financial transparency, quality, and comparability, thereby reducing issues in accounting practices and the costs associated with assessing investment risks.

Tommasetti et al. (2021) introduced the Fraud Hexagon framework, providing insight into the workflow of fraud, starting with financials as a prerequisite for accounting fraud. The framework addresses key questions such as the identity of the fraudster, the defrauded party, materiality, consequences for involved parties, and the regulatory oversight role of watchdog entities. Each component of the hexagon is discussed sequentially, shedding light on the intricacies of fraudulent activities.

3.1. Craetive Accounting Characteristics

Creative accounting encompasses a variety of practices aimed at manipulating financial statements to portray a positive image of the entity, creatively addressing issues, and prioritizing management interests over accurate financial representation within the social context of accounting (Floştoiu, 2022). Shevchenko and Liadska (2015) elaborate on these characteristics, emphasizing the practice's impact on addressing cost issues, manipulating financial statements, and influencing accounting principles positively and negatively. They underscore the importance of ethical and professional judgment in accounting practices.

Adeosun et al. (2021) explore the impact of creative accounting on accounting information characteristics, including reliability, relevance, verifiability, neutrality, completeness, and faithful representation, as perceived by accounting educators and practitioners. In the banking sector, Abed et al. (2022) emphasizes the impact of creative accounting characteristics on stakeholders' perceptions. This influence may potentially result in fraudulent financial reporting by manipulating financial indicators within legal boundaries. Remenarić et al. (2018) point out specific characteristics such as overstating assets, high stocks, and presenting provisions as assets to manipulate financial information.

Vega Falcón (2020) underscores the undesirable nature of creative accounting characteristics, which involve the manipulation of financial information by leaders and accountants to show misleading results. Androniceanu and Strakova (2021) discuss characteristics such as window dressing and off-balance sheet techniques, which are aimed at manipulating financial statements in a global business environment. Matić (2018) notes the use of permitted and unpermitted procedures to align financial statements with the reporting entity, often deviating from presenting true financial outcomes. Blazek et al. (2020) examine characteristics specific to the agribusiness sector in the Slovak Republic, including manipulating financial statements and adjusting tax bases to show improved economic values.

Oncioiu et al. (2021) explore characteristics such as leveraging fair value, diverse accounting systems, and subjective interpretations to manipulate business performance. Asif et al. (2016) discuss income smoothing, expense assetization, and other manipulative techniques to enhance profitability or net worth. Diogo (2018) warns against the abusive practices of creative accounting, which can mislead stakeholders and result in potential legal consequences. Stašević & Stavanović (2019) focus on the characteristics in income statements, such as manipulating expenses and revenue recognition, commonly used by Serbian entrepreneurs to reduce tax obligations. Meredith et al. (2022) observed varying levels of creativity among accountants in regional firms. These levels are influenced by firm culture and hierarchical positions, although they are not directly related to characteristics of creative accounting.

Stašević and Stavanović (2019) highlight characteristics of creative accounting in income statements, including the manipulation of expenses, overstating assets, and premature revenue recognition. These practices are commonly employed by Serbian entrepreneurs to minimize tax obligations rather than inflate financial performance. Abu and Adetula (2015) discuss characteristics of creative accounting involving deviation from the spirit of accounting rules. This can lead to the misleading of stakeholders and potentially inflate share prices, thereby impacting investors' decision-making. They emphasize the significance of ethical accounting practices in mitigating these negative effects.

De Jesus et al. (2020) elaborates on creative accounting practices, such as recognizing expenses as intangible assets and prematurely recognizing revenue from services not yet provided. They highlight accountants' perception of creative accounting as distinct from fraud, focusing on leveraging accounting standards to portray a desired image of the company. Susmus and Demirhan (2013) argue that creative accounting involves manipulating revenue recognition and expense accounting to present a stronger financial image without violating Generally Accepted Accounting Principles (GAAP). They suggest that the intention of creative accounting is to present stronger financial statements.

Mirdan and Manhel (2017) describe creative accounting as practices that may comply with accounting rules in form but not in spirit, using complexity and novelty to influence interpretations. Examples include concealing poor company performance, artificially enhancing results, and distorting figures to avoid takeovers. Butala and Khan (2008) present a case study of Xerox's involvement in creative accounting to achieve financial targets. They outline tactics such as aggressive accounting methods, income overstatement, and the use of 'cookie jar' reserves, which deviate from GAAP standards to boost quarterly income.

The characteristics of creative accounting encompass the strategic manipulation of financial data to project a more favorable portrayal of a company's performance and financial health. This practice often entails exploiting loopholes and ambiguous areas in accounting standards to boost profitability, enhance liquidity ratios, or conceal underlying financial vulnerabilities. By creatively interpreting accounting principles and standards, organizations can sway stakeholders' perceptions and decision-making processes. In this exploration, we will delve into the fundamental features of creative accounting, probing into the motivations propelling this practice and its implications for financial reporting and analysis.

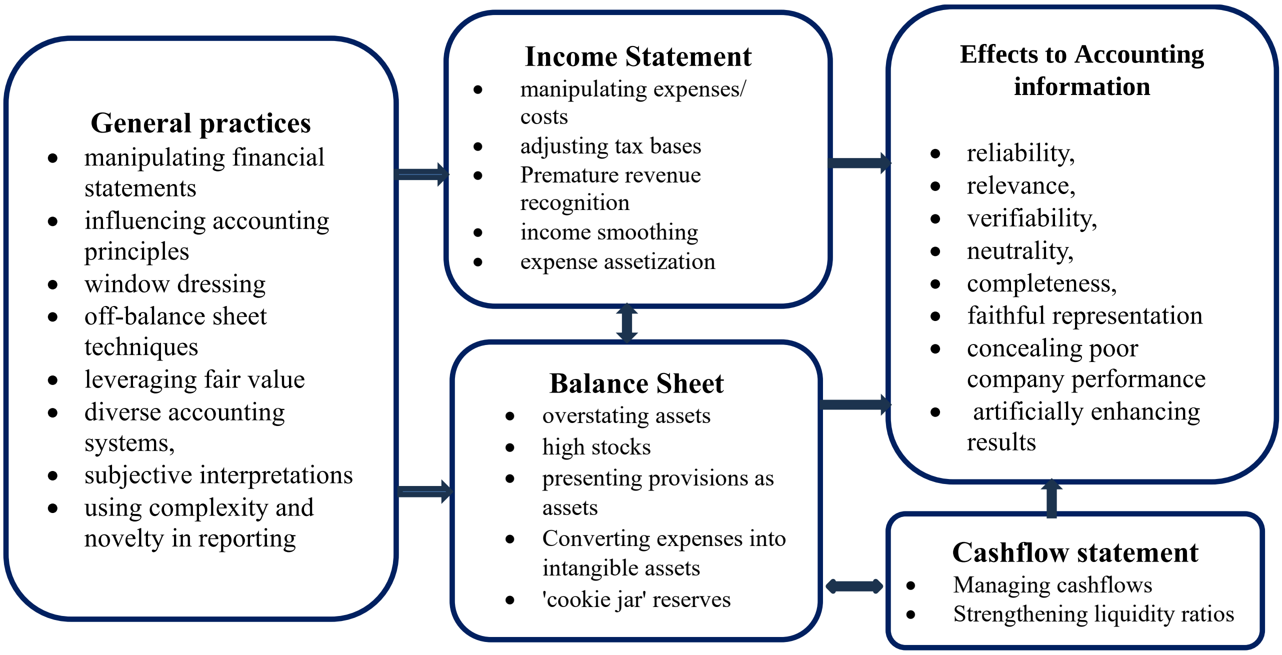

Figure 2 Summary of Creative Accounting characteristics

Figure 2 presents a detailed overview of the characteristics associated with creative accounting practices in various aspects of financial reporting. Within the general practices category, it identifies a range of methods that organizations may utilize to manipulate financial statements, including influencing accounting principles, window dressing, and leveraging fair value. The figure also acknowledges the presence of diverse accounting systems and the subjective nature of interpretations in financial reporting, often combined with the use of complexity and novelty to obscure information.

Transitioning to specific financial statements, the income statement segment delineates techniques such as manipulating expenses, adjusting tax bases, premature revenue recognition, income smoothing, and expense capitalization. These practices have the potential to distort a company's true financial performance and deceive stakeholders.

The balance sheet section outlines strategies such as overstating assets, maintaining high stock levels to inflate asset values, presenting provisions as assets, and converting expenses into intangible assets. Additionally, it discusses the significance of fundamental principles in financial reporting, such as reliability, relevance, verifiability, neutrality, completeness, and faithful representation, while also addressing the concealment of poor company performance. Lastly, the cash flow statement section examines methods used to manage cash flows and improve liquidity ratios through creative accounting practices, which may not provide an accurate reflection of the financial health of the organization. In summary, Figure 2 illustrates the wide range of tactics used in creative accounting to manipulate financial statements, which could compromise the reliability and transparency of financial information provided to stakeholders.

Characteristics of creative accounting encompass a wide range of deceptive practices aimed at distorting financial data. These practices include manipulating figures, recognizing revenue in an overly aggressive manner, inappropriately timing the recognition of expenses, employing intricate structures to obscure crucial information, and providing misleading disclosures to stakeholders. This deceptive practice involves manipulating and bending accounting regulations and principles to create a distorted but more positive representation of a company's financial performance. This can potentially mislead investors and stakeholders, leading to uninformed decisions.

3.2. Forms of Creative Accounting

Forms of creative accounting encompass a variety of techniques employed by managers to influence financial statements and stakeholder perceptions. El Diri et al. (2020) delineate earnings management characteristics, which include accrual earnings management, real earnings management, earnings smoothing, and income shifting. These methods allow managers to manipulate reported earnings to meet desired outcomes. De Jesus et al. (2020) shed light on accounting scandals and practices, such as earnings management and income smoothing, contributing to a deeper understanding of fraudulent financial reporting. These forms of creative accounting often involve manipulating financial data to misrepresent the true financial position of a company. Cugova and Cug (2020) delve into the manipulation of financial results, tax minimization, and the use of various techniques such as window dressing and off-balance sheet financing to serve the interests of different stakeholders.

Brauweiler et al. (2019) discuss "big bath accounting" as a form of creative accounting where worse-than-expected results in a bad year are reflected in the financial statements. Income smoothing, on the other hand, may be perceived as necessary by managers to avoid signalling negative outcomes to investors. These practices can create an environment conducive to creative accounting, highlighting the importance of corporate governance in mitigating such behaviors. Ndebugri and Tweneboah (2017) examine the impact of creative accounting practices on accounting policy selection and decisions in the corporate sector of Ghana. They identify subjective depreciation of assets as one of the techniques used in creative accounting to manipulate accounting figures and present a favorable financial image.

Various forms of creative accounting are employed by managers to impact financial statements and stakeholder perceptions. These include earnings management techniques such as accrual earnings management, real earnings management, earnings smoothing, and income shifting. Additionally, strategies like window dressing and off-balance sheet financing are utilized to manipulate financial outcomes in alignment with different stakeholders' interests. Another method known as "Big bath accounting" involves presenting worse-than-expected results during a poor financial year. Managers may view income smoothing as essential to prevent signalling negative results to investors. Effective corporate governance is vital in addressing and reducing the prevalence of creative accounting practices.

3.3. Implications of Creative accounting

Saleh et al. (2023) underscore the importance of careful consideration in financial decision-making, highlighting correlations between various factors such as technical aspects, tax evasion, and income manipulation, and their impact on financial statements. In the study by Kamau et al. (2012), it is suggested that tax avoidance and evasion are significant contributors to the adoption of creative accounting by companies. Saleem (2019) focuses on the motives driving creative accounting practices in Jordan, emphasizing factors such as tax reduction and maximizing returns on investments. This study emphasizes the importance of generating empirical data on tools for creative accounting and comparing them with existing literature to identify relationships and discrepancies.

Mutinda (2023) explores the factors that influence income smoothing practices among manufacturing firms in Kenya. The study emphasizes regulatory frameworks, managerial incentives, industry competition, economic conditions, and access to capital markets. This literature review provides insights into the complex dynamics driving creative accounting practices. Blazek (2021) discusses the characteristics of creative accounting, including the generation of new ideas in financial statements and the utilization of analytical models such as Beneish and Modified Jones. The study highlights the challenge of fully detecting creative accounting on a global scale.

Salameh (2019) proposes mechanisms to prevent fraud through creative accounting, focusing on risk perception and structured approaches to identify and reduce manipulation in financial data. The study develops a model to understand creative accounting, involving parties such as banks, auditors, and regulators in manipulating accounts within or beyond regulatory requirements. Akenbor and Ibanichuka (2012) examine recent cases in Nigeria where creative accounting has been used to cover up inadequacies and perpetrate fraudulent deals. They highlight the unethical nature of creative accounting and recommend streamlining accounting principles and adopting strict measures to prevent its practice.

Foster et al. (2013) discusses the reliability dimension in auditing, emphasizing the impact of audit reports' wording on the perception of financial information and the importance of internal control systems in producing accurate financial statements. Ezeagba and Abiahu (2018) emphasize the role of professional ethics in guiding the conduct of professional accountants and protecting both clients and professionals. They highlight the importance of acting in the best interest of the public to enhance the profession's reputation. Duh and Djokić (2021) assessed transparency and disclosure practices in Slovenian public joint stock companies, noting the need for improvements despite positive governance practices influenced by various regulations. They emphasize the impact of legislation, regulations, and recommendations on governance practices in listed companies.

In summary, various factors such as regulatory frameworks, managerial incentives, industry competition, economic conditions, and access to capital markets can either influence or be influenced by the practice of creative accounting. Detecting creative accounting practices on a global scale poses challenges. However, analytical models such as the modified Jones model, bottom-up approach, and Beneish model can assist in identifying the presence of creative accounting. Establishing mechanisms to prevent fraud resulting from creative accounting involves focusing on risk perception and implementing structured approaches, which is critical. Given the unethical nature of creative accounting, there is a need to standardize accounting principles and enforce strict measures. The reliability dimension in auditing has influenced the wording of audit reports and emphasized the significance of internal control systems. Professional ethics play a crucial role in guiding the behavior of professional accountants and safeguarding the interests of clients and professionals. Despite the presence of positive governance practices influenced by regulations, there remains a need for companies to enhance transparency and disclosure practices.

4. Discussions

The literature presents a comprehensive understanding of creative accounting, highlighting its fundamental determinants, characteristics, forms, and associated Implications. The phenomenon of creative accounting is influenced by various factors, including ethical considerations, disclosure quality, internal control, and ownership structure. Administrators' ability to selectively manipulate accounting aspects to enhance perceived attractiveness is evident, with potential implications for stakeholders. This includes misleading users and investors, hindering corporate growth, and impeding investment mobilization. Moreover, the literature emphasizes the dual nature of creative accounting, with positive aspects such as innovation in accounting principles and techniques, alongside negative aspects involving unethical practices aimed at misleading stakeholders. This duality underscores the complexity of creative accounting and its implications for financial reporting and decision-making.

Creative accounting refers to a variety of techniques used by managers to manipulate financial statements and stakeholder perceptions. These techniques include earnings management, income smoothing, and big bath accounting. These practices underscore the importance of corporate governance in mitigating such behaviors and ensuring financial transparency and accountability. The Implications associated with creative accounting highlight the need for careful consideration in financial decision-making, especially concerning technical aspects, tax evasion, and income manipulation. Additionally, the significance of regulatory frameworks, managerial incentives, and ethical considerations is emphasized in understanding and addressing creative accounting practices. The literature review provides a comprehensive overview of creative accounting, including its determinants, characteristics, forms, and associated Implications. However, there are several areas where further discussion and analysis could enhance the understanding of the topic.

Firstly, the literature highlights the fundamental determinants of creative accounting, such as ethical issues and disclosure quality. However, it could delve deeper into the specific mechanisms through which these determinants influence creative accounting practices. Additionally, the discussion could explore potential mitigating factors or strategies to address these determinants and reduce the prevalence of creative accounting. Secondly, while the review discusses various forms of creative accounting, such as earnings management and income smoothing, it could provide a more in-depth analysis of each form, including their prevalence, motivations, and implications for financial reporting and decision-making. Furthermore, the review could examine emerging forms of creative accounting and their impact on the evolving regulatory landscape. Lastly, while the Implications associated with creative accounting are discussed, the review could explore potential strategies or interventions to mitigate the risks associated with creative accounting practices. This could include regulatory reforms, enhanced transparency and disclosure requirements, and increased accountability measures for corporate governance.

5. Conclusion

The characteristics of creative accounting may encompass different aspects, including the overstatement of revenue, which involves recognizing revenue prematurely or from transactions that do not meet revenue recognition criteria, and the understatement of expenses, which encompasses postponing expense recognition, capitalizing costs that should be expensed, or underreporting expenses incurred. Furthermore, the manipulation of reserves and accruals is another characteristic, involving the creation of excessive reserves or accruals of income or expenses to stabilize earnings and manipulate financial performance.

Additionally, the shifting of expenses or revenues between reporting periods is a common practice aimed at artificially inflating or deflating earnings for a specific period. Misclassifying or reclassifying items is another aspect of creative accounting, where financial transactions are categorized in a manner that distorts their true nature and misrepresents their impact on financial statements. Moreover, the fraudulent alteration of accounting records, which includes falsifying or manipulating financial data by creating fictitious transactions, inflating asset values, or concealing liabilities, is a significant characteristic of creative accounting.

Insufficient or misleading information disclosure is also part of creative accounting, involving the intentional omission or provision of inadequate information in financial statements, notes, or disclosures to deceive users of financial statements (Kramárová & Valášková, 2020). Furthermore, manipulating fair value estimates is another common practice within creative accounting, entailing the modification of asset or liability valuations based on subjective assessments, such as altering assumptions or judgments to increase or decrease the fair value of specific assets or liabilities, thereby distorting the financial position. These characteristics are often motivated by various factors, including the aspiration to meet financial targets, boost stock prices, or secure financing.

Moreover, creative accounting characteristics can be influenced by factors such as the compensation structure of management, pressure from shareholders or investors, the competitive landscape, and the overall corporate culture (Gupta & Kumar, 2020). In essence, creative accounting characteristics encompass a range of manipulations and misrepresentations in financial statements, including the creation of fictitious transactions, inflation of asset values, and concealment of liabilities. These actions are typically driven by the desire to achieve specific financial objectives, meet targets, or create a misleading impression of the financial well-being of the company.

The study's implications encompass a thorough investigation of creative accounting, examining its root causes, distinguishing features, various manifestations, and associated cautions. Furthermore, the study underscores the necessity of prudence in financial decision-making and highlights the crucial role of regulatory structures and ethical behaviour in managing the risks associated with creative accounting activities. It suggests that future research should focus on examining the importance of regulatory frameworks, managerial motivations, and ethical considerations in addressing creative accounting practices. Additionally, exploring the potential efficacy of early warning indicators in identifying forthcoming financial misrepresentations is recommended.

Compliance with ethical standards

Disclosure of conflict of interest

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