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Creative Accounting: An Overview of Its Practices Where are We Heading Now?

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Abstract
Accounting plays a significant role in the contractual relations that form the modern corporation, presumably to mitigate agency costs. However, it is argued that preparers are likely to have incentives to convey self-serving information is also likely to impose costs on financial statement users. This practice known as creative accounting which referring to the process of taking deliberate steps within the constraints of GAAP to bring about desired level of reported earnings. Even though not all accounting choices involve creative accounting or earnings management, and the term earnings management extends beyond accounting choice, the implications of accounting choice to achieve managers' personal goals are consistent with the notion of earnings management. Accounting is a medium for managers to disseminate privately held information through accounting information releases, and the specific accounting method choice can play a key role in that communication process. In addition to that, regulation of accounting affects the quality and quantity of financial disclosures, and thus affecting the quality of decision making of the users. This paper critically discusses the common motivation, techniques, the implications, potential mitigation mechanisms as well as reviews some of the most controversial accounting scandals in Malaysia and worldwide. We conclude that earnings management are still a very common practice despite the current development in various mitigating mechanisms.
Keywords: Creative Accounting, Earnings Management, Accounting Scandals, Control Mechanisms

Introduction

Every company is required to prepare financial statements at the end of the financial year reporting. Financial statements are the medium to provide a clear overview of an organization's financial position in terms of its financial performance, operations, and cash flow. Thus, it is essential for every company to prepare its own financial statements as for the shareholders and other users making decision. Besides that, financial statements will also be used to attract the attention of an investor to invest in the company. They will choose to invest in a company that has good financial performance with the goal of achieving profit maximization. Thus, the company should ensure the information contained in the financial statement reflects its own true financial condition.

Ideally, to achieve the above mentioned objectives, the accountant should ensure its compliance with accounting standards and frameworks such as Generally Accepted Accounting Principles (GAAP) and financial reporting standards while preparing financial statements. However, when preparing financial statements, an accountant must not only adhere to the accounting standards but also to the demands and objectives of management which sometimes are not aligned together. To portray a good financial statement, some companies ordered their accountant to manipulate the financial statements to provide misleading information. The term "manipulation" is no longer unfamiliar to us. One of the first researchers to adopt the term "accounts manipulation" was (Copeland, 1968). As a matter of fact, accounting manipulation is still being done by some companies, whether it is known to the public or not despite many remedial actions and proposal have been introduced to date.

Accounting scandals such as Healthsouth, Lehman Brothers, Transmile Group, and Perwira steel are those classic scandals examples that have committed manipulation of financial statements. These companies had the intention to present healthier financial statements so badly, hence have practiced creative accounting in preparing their financial statements. Even though creative accounting is not illegal, it is however resulting deceptive information and considered unethical as it is against the accounting standard. In addition, this practice still have a negative impact on the company and the users of financial statements.

To conclude, despite the implementation of several corrective measures and proposals, certain companies are still engaging in accounting manipulation, which motivates this paper to examine this situation critically. Thus, this review could contribute by critically examining accounting manipulation in financial statements, analyzing its effects on businesses and financial statement users, and determining why some companies continue to engage in such practices despite corrective measures and proposals. It could recommend ways to prevent and detect accounting manipulation, emphasizing the importance of transparent and accurate financial reporting and the need for companies to follow GAAP and financial reporting standards to ensure that financial statements accurately reflect the company's financial condition.
In conclusion, ethical accounting practices, investor confidence, and business longevity are essential. Thus, an ethical accounting system can prevent accounting manipulation in financial statements, promote transparency and accuracy in financial reporting, and help businesses succeed long-term.

Motivations for Creative Accounting and Earnings Management
Financial reporting is often believed and expected to be a transparent, true and fair view that users can refer to understand the company's operations and performance throughout the year. However, even if the report appears to be true all the time because it has been prepared by the professional, it does not mean that there will be no misinterpretation, misinformation, or fraud in the report. This issue may occur without the stakeholders being aware of it because accountants will use their knowledge and skills to perform manipulations without

violating laws, regulations, policies, and the accounting standards. This practice is known as creative accounting and/or earning management where accountants will take the opportunity by misusing the accounting methods to make the financial reporting as what the company is desired.

The definition of creative accounting is differing among the scholars. Cugova and Cug (2020) define creative accounting as creating an economic "tunnel" in a company and substituting an old (nonprofit and troublesome, on the verge of bankruptcy) with a new and lucrative (trouble-free, viable). Creative accounting is also defined as any managerial activity that artificially inflate the reported income but delivers no genuine economic benefit to the companies and eventually will become very harmful in the long run to both the company and the users (Merchant & Rockness, 1994).

Motivations for creative accounting are various. Some of those motivations are discussed here. First motivation is related to the managers' initiatives. Top management has an interest in making the financial statements of the company look better than what they actually are. Due to that, the managers are pressured to impress the management that the interests of the top management could be achieved. The manager has a greedy nature to obtain personal gains. There are several types of personal gains that can be achieved, such as increased salaries, bonuses, job security, achieving high profit and good prices for the shares, and personal satisfaction (Ciocan, 2020). Because of their self-interest, it prevents the manager from reporting the truth about the company's situation to avoid being criticized as well as not able to maximize their personal gains. Thus, it drives them to use creative accounting techniques and simultaneously ignore the interest of the shareholders to make an optimum decision based on the financial statements. The theory related to this motivation is the agency theory. Agency theory is the principle that is used to explain and resolve issues in the relationship between business principals and their agents. Agency problems will always arise when the principal (shareholder) employs the agent (management) to perform the duties in the best interest of the agent for a reward. A conflict of interest will eventually exist between the management and shareholders. This is due to the agency theory's assumption that managers are self-interested, self-serving, individualistic, and optimistic in nature, and solely want to maximize their personal interests at the expense of the owners (principals). Based on Jenson and Meckling (1976), agency problems could also arise due to adverse selections and moral hazards. Moral hazard refers to a situation where due to imperfections in the contract between the principal and the agent, the management may take sub-optimal decisions and may be opportunistic (Adelopo, 2010). In this case, the manager has ignored the shareholder interest to achieve his personal interest.

Next motivation for creative accounting is the urge to attract the investors. It is argued that company tends to make misrepresentations of financial statements to attract as many investors as possible as to secure the demand for equity market shares. As the aim of investors is to gain profit maximization, it encourages companies to distort economic results and present overstated profit. This notion is consistent with capital market research under the efficient market hypothesis. Capital market research solely focuses on the investor's reaction to the release of financial information. There is an underlying assumption in capital market research that the equity market seems efficient. An efficient market refers to a market that responds quickly to completely integrating information into share prices when it is disclosed. Assumptions about market efficiency have implications for accounting. It states that if markets are efficient, they will use information from different sources when estimating future earnings and hence when determining current share prices. Thus, it could be said that the financial information of the company is important to determine the investor's reaction, whether to make an investment or not. The healthier financial statements performance is likely to have a chance to attract investors' attention.

Further, based on the arguments of opportunism and feasible foresight, managers may also engage in earnings management at more favorable terms, such as higher issuing price. For example, prior studies also document that managers manipulate earnings in the periods of equity offers i.e., report positive (income increasing) unexpected accruals prior to seasoned equity offering (Rangan, 1998; Teoh et al., 1998; Yoon and Miller, 2002). Not only the quality of reporting affecting external users' decision making, McNichols and Stubben (2008) show evidence that the quality of earnings affects the internal decision as well. McNichols and Stubben (2008) argue that the management may be misled due to two plausible factors; (1) the management tend to be over-optimistic, or (2) genuinely unaware of the misstatement.

Thirdly, the motivation of creative accounting is also related to its impact on a business environment. The influence of internal and external factors on business decision-making is referred to as the business environment. For the companies to recognize its position and opportunities threats in the market hence the company is required to do analysis towards the environment. One of the important elements is the impact of the tax system on the company as I will directly influencing the amount of the tax expenditure of the companies. Thus, it is argued that the national tax system is also one of the major reasons for undertaking creative accounting. The theory that can be related is the positive accounting theory, which is more focused on the political costs hypothesis. Political cost refers to the cost imposed on the company by a specific interest group, such as increased taxes, wage increases, or product boycotts. The cost incurred to the company is influenced by the results of financial statements. For example, assuming that the company is making a high profit, and the company is required to pay increased taxes due to its ability to pay. It will be used as an excuse by a particular interest group to impose that cost on the company. In this context, a particular interest group can be referred to by the government, trade unions, environmental lobby groups, and others. Therefore, the higher a company's political costs (increased taxes), the more likely the company is to adopt accounting methods that help in delaying reported earnings.

Techniques of Creative Accounting

As discussed in the previous section, creative accounting is implemented by taking advantage of the flexibility of accounting methods and standards as different methods will give different results. Thus, creative accounting techniques are being chosen by the management to fulfill their desired outcomes. There are several techniques to accomplish creative accounting such as "income smoothing", "big bath", cookie jar reserves, window dressing, and off-balance-sheet financing and many others.

One of the commonly discussed types of creative accounting exercise is income smoothing (see for example (Demerjian et al., 2020; Obeidat, 2021; Setyani, 2022). It is argued that income smoothing is purposeful intervention by the managers into both operating and reporting processes to reduce the volatility of reported earnings (Acharya & Lambrecht, 2015; Graham et al., 2005). Income smoothing refers to the modification of income levels to provide an indicator of business performance that management objectives can be achieved (Saleem 2019).

More interestingly, it is also argued that the intentional smoothing can be achieved through the ongoing and overtime use of income increasing and income-decreasing as well as real activities earnings management (Demerjian et al., 2020). The motivation for income smoothing is twofold. Some research provides evidence that some income are managed with the intention to deliberately distort the reported performance to benefits the manager at the expense of other stakeholders (e.g., (DeFond & Park, 1997; Lang et al., 2012). On the other hand, it also argued that income smoothing practice is an alternative to signal some private messages to the users suggesting some elements of improving the usefulness of earnings including in the contracting activities(Sankar & Subramanyam, 2001).

Next, is the big bath method that is argued to be always associated with income smoothing (Ghorbani et al., 2020). According to Tokuga and Yamashita (2011), the big bath method is the attempt to boost reported earnings in coming periods by charging items that may have a negative future impact on current period costs, thereby deteriorating current period business outcomes in an accounting period with poor results (Ayedh et al., 2021; Hope and Wang 2018). This technique is also deemed as an unethical accounting technique because it intends to make a poor result in a bad year so that the company can portray better results in future years. This situation will undeniably mislead the users. One of the simple examples is the company can use the big bath technique in the pandemic COVID-19 by taking advantage of the poor market conditions during the pandemic. The company will be likely to incur a large expense during the pandemic year and its expenses will be reduced in the year when an endemic has been declared and the market conditions are much better as compared during the pandemic. As the result, the users will misallocate their funds believing that the companies were doing well during the pandemic, and eventually unable to maximize their wealth because of the wrong decision made based on those misleading information.

Further, is the cookie jar reserves method. This method is a technique of over-provisioning accrued expenses when the revenues are high, thus making the profits to be brought down to a level that is safe to maintain in the future (Shah & Butt, 2011). This technique is usually implemented when the company's performance fails to meet its expectations, so what the company can do is by keeping its income in the current quarter and carry forward it into the future quarter to make it appear as a higher income in that quarter.

Another common technique is known as "Off-balance-sheet financing technique". This technique is usually associated with financial risk coverage and aims to eliminate risks associated with the company's debts and solvency (Cugova & Cug, 2020). This technique requires a much broader experience and qualification of an accountant as the aim is to find ways how to change financing to become funds from the outsiders. The company can recognize its guaranteed loans as sales or recognize loans as equity as the objective is to distort the profit.

Creative accounting also can be executed by using a window dressing technique where transactions are deliberately performed thus the results will portray the desired state of an image that is contrary to the true image of the company's state (Cugova & Cug, 2020). The reason behind this technique is to depict the business's performance as the best so that external users will be likely to give loans, grants, and the company manage to attract the potential investor to invest in its company. The common techniques of window dressing include asset repurchases, distorted revenue recognition, fictitious revenue recognition, classifying short-term assets and liabilities as non-current, etc. All these window dressing tactics are described as a balanced practice between creative accounting and fraudulent accounting, which takes advantage of loopholes in rules and legislation.

There are many accounting scandals examples that have previously shocked us all. The US Securities and Exchange Commission (SEC) accused HealthSouth of an accounting scam in which the company's earnings were illegally exaggerated by USD1.4 billion. HealthSouth was charged with Securities Exchange Act violations in 1998 for neglecting to disclose unfavorable trends and misrepresenting the company's financial information. HealthSouth’s founder, chairman, and CEO, Richard M. Scrushy, was accused of directing company employees to falsely report grossly exaggerated company earnings to meet stakeholder expectations. The Securities and Exchange Commission (SEC) then has taken action against HealthSouth in connection with this corporate accounting scandal in which In March 2003 and has indicated that it was also looking into whether Scrushy's stock sale had anything to do with HealthSouth's big loss. Scrushy was charged for fraud by HealthSouth investors in 2009, and he was compelled to reimburse USB2.8 billion.

Next is Lehman Brothers. Lehman Brothers was in the United States of Alabama and was significantly involved in subprime lending, which was fueling unsustainable economic expansion. Between 2003 and 2004, Lehman bought five mortgage lenders, including one that specialized in subprime mortgages, which were granted to borrowers with poor credit. Investors and rating agencies began to lose faith in Lehman and its investment banking rivals as the real estate market weakened and investors and rating agencies expressed major worries about these sorts of assets due to their lack of liquidity in the market. Using accounting loopholes that is creative accounting, the business was found to have disguised more than USD50 billion in loans during the 2008 financial crisis, disguising them as sales to avoid the appearance of hazardous assets. The financial positions showed favorable cash available when they actually did not have, by selling toxic assets to banks in the Cayman Islands with the promise to buy them back in the future. More surprising, this accounting scandals was also made through collaboration with Ernst & Young, their auditor. On September 15, Lehman Brothers declared bankruptcy with USD639 billion in assets and USD613 billion in debts, making it the largest bankruptcy filing in U.S. history.

In Malaysia, there are also a number of accounting scandal cases has been recorded. One of the examples is Perwaja Steel. Perwaja Steel encountered some mismanagement issues and was further burdened with a substantial amount of debt in 1986. The situation gets worsen, since e the borrowings were made in yen, thus the interest payments were kept increasing substantially. In addition to that, Nippon Steel Corporation withdrew from this collaborative project in 1987 making Perwaja Steel’s situation became more difficult. Perwaja Steel has received government funding of RM 2 million, a loan from Bank Bumiputra (RM860 million) and EPF (RM130 million). It was all begun when Eric Chia claimed that he had successfully increased the performance of Perwaja, but after he resigned in 1995, it was revealed that his claim was false. As a matter of fact, it was instead an increase in the total loss in Perwaja RM 1 billion to RM 2.49 billion when he managed the company. Perwaja also faced additional debts of RM5.7 billion. PWC has conducted an audit and it was discovered that Perwaja Steel used creative accounting in the company. It is proven when they get involved in suspicious transactions with a Japanese company called NKK, which was later shown to be a non-existent company. The auditor also claimed that Perwaja Steel had engaged in fraudulent activities. Eric Chia was finally charged for dishonestly authorizing (not pocketing) a payment of RM76 million (0.076 billion) in 2004. RM76 million is a lot of money but it is extremely small compared to the total loss estimated to be more than RM10 billion.

Another example is an accounting scandal that occur in year2007, where Transmile was involved in an accounting scandal related to misstatement of revenues. It was started when Transmile failed to comply in submitting its audited annual accounts for the financial year ended 31 December 2006 to Bursa Malaysia. As per obliged by the Listing Requirements of the Exchange, Transmile is supposed to send the audited financial statements to Bursa Malaysia four months earlier from the financial year end. After Transmile was unable to retrieve approval and signature from their external auditors, Deloitte & Touche as the external auditors believed Transmile did not have sufficient supporting documents for the year and finally revealed the accounting scandal involving overstatement of profit from year 2004, 2005 and 2006 during the special audit period.

Implications of Creative Accounting

Based on the above discussion, we can somewhat conclude that that most of the creative accounting techniques and their associate motivations are always with manipulative intentions. In other words, managers can always exercise these various judgment as to 'mislead' shareholders about underlying economic performance of the firm as to achieve some self-dealing benefits (Benish, 2001). The managers of the company are the one responsible for the misuse and abuse of creative accounting in order to fulfill their selfish motives they defy the ethical considerations which are an essential part of creative accounting (Nag, 2015). This can give a negative impact to the society and other affected stakeholders such as investors, creditors as well as employees. The practices of creative accounting which are totally unethical and out of the limits of accounting studs. It may lead to uncontrollable situations imposing a threat to the very existence of the company. The company will always be at a high risk of losing its investors because in case the investors get to understand the manipulations, it will give the worst scenario to the company. The investor's interest might get hampered. Because these practices give a firm only short-term benefit. The improper use of such creative accounting practices had led to reputational damage of the company. The company may lose its business and dearly earned reputation as the expectation from the company by their stakeholders are at risk. Creative accounting distorts reality, which may mislead users of financial statement information and is therefore generally considered unethical.

Nonetheless, despite all the potential harms, Beneish (2001) argues that creative accounting is not necessarily always opportunistic. Beneish (2001) proposes two perspectives on earnings management: (1) the opportunistic perspective with the notion that managers seek to mislead investors as to meet their personal economic objectives and (2) the information perspective with the notion that managers use earnings management as to reveal (or signal) their private expectations about firm's future cash flows to investors. This notion can always be seen for example within the income smoothing practice. in other words, the use of creative accounting techniques somehow is beneficial for financial reporting. If creative accounting adheres with ethical and legal standards as well as the generally accepted accounting principles (GAAP), they can results some advantages to both firms and its stakeholders (Shah et al., 2011). Creative accounting is in essence not illegal, and investors may sometimes even benefit from the practice. Creative accounting is argued to be able to maintain or boost the share price by making the company appear subject to less risk, and creating a good profit trend appearance (Blake et al., 1999). From that, the company is able to raise capital from new share issues as well as resist any potential takeover. The companies can decide to misstate the financials, which leads to adopting creative accounting practices, meeting the expectations of the capital market, so that share prices show a favorable trend. Higher credit ratings which lead to lowering borrowing costs for the firm also serves as another reason for the adoption of such practices. Apart from that, companies who adopt creative accounting techniques can show good financial performance in order to attract investors in the short run. The company can also somewhere conceal any financial risk which they may tend to suffer. This helps to enhance the performance of the business and bring high returns on their investments to the shareholders. Creative accounting is argued to produce a stronger or weaker look of company's financial position depending on the aspirations of management. Using creative accounting practices, management can alter impressions about their firms' business performance (Mokhlis, 2019).

Suggestions on Potential Mitigation Mechanisms

The potential harmful effect of creative accounting practice can be mitigated consistent with the notion of Agency Theory where the agency costs is argued can be minimized, The first potential mitigation mechanisms in preventing practice of creative accounting includes the strengthening the corporate governance structure good corporate code of ethics, as to promote better control and monitoring, thus limit the excessive creative accounting. Next, is to create high ethical work and corporate culture with continuous professional and ethics training among the accountants and the top management. As a result, accountants' personal and social responsibility is increased through the development of leadership skills, making them more resistant to fraud and data manipulation. Leadership and power through soft skills can deal with new challenges. Most scholars agree that there are two factors can make it possible to face changes effectively. Firstly, related to the fundamental system that is, an organization must prepare the ground for all the processes that will take place in the organization. As an illustration, applying corporate governance principles. The second factor is the level of comprehensive skills of the organization's leaders. In an ever-changing world, the development and cultivation of the company employees' leadership skills is an integral part of the organization's strategy. It is due to there is the possibility of increasing accountants' responsibilities by developing leadership skills to avoid manipulations of financial information (Brauweiler et al., 2019)

Further, is by enhancing internal control. Good internal control could be one of the possible potential mitigation mechanisms in preventing practice of creative accounting. Internal controls that are well-defined and well-established can improve the integrity and reliability of financial reporting produced by an organization. The presence of controls shall prevent the possibility of implementing inappropriate accounting practices. The adoption of internal control is vital for improving the quality of financial reporting. Thus, it could be concluded that an inefficient internal control causes a misstatement in the quality of financial reporting and creates more room for accounting manipulation.

Next is the role of the external audits. The role of external auditors is also found to be one of the most effective techniques to prevent creative accounting. Usually, based on those accounting scandals stated, it cannot be denied that the manipulation in financial statements is done by the internal parties of the company. Meanwhile, the external audit includes the view and checking from the expert, which is an external auditor. Even though external audits may not be able to entirely prevent unlawful creative accounting, the presence of the external auditors, especially those with vast experience, are usually better at detecting creative accounting. Thus, not only because the external auditors will catch creative accounting practices, but the presence of external auditor creates a fear of being caught will hinder manipulators from doing so. In other words, even if auditors do not always discover creative accounting, external audits act as a psychological barrier as a standard procedure. The fear of being caught limits the perceived opportunity, which is one of the motivators for fraud.

Subsequently, giving awareness to employees and management in terms of corporate governance ethics, and whistleblowers policy. The awareness shall be held regularly to produce effective works and as a reminder to fellow workers to work with ethics and avoid unethical practices by clearly stating practices that may lead to improper conduct. As for whistleblower policy, it is to ensure fellow workers who stumble with unethical problems to not have any hesitation to make reports to improve the working and corporate environment. Other than that, companies shall emphasize more to investors on the application of forensic accounting and its development as it is one of the effective ways to reduce the manipulation of accounting records. Moreover, the consistency of national authorities to enforce the penalties is encouraged. Even though creative accounting cannot be removed wholly, it can be reduced by applying the above ways consistently.

Conclusions

Creative Accounting offers a formidable challenge of the accounting profession which when carried to extreme negativity has cast aspersion on the credibility of accounting principles and standards (Mirdan, 2017). Managers are motivated for a variety of reasons to engage in creative accounting and as a result, auditors must be cautious and auditing services for clients should be broadened to assist them in ensuring the integrity and reliability of financial reporting. The timing of genuine transactions and existence of classificatory smoothing are clearly the discretion of the management in order to give a good impression on the accounts. On the other hand, from an ethical perspective financial statement manipulations can be regarded as morally unacceptable. Both the auditors and managers have some ethics to the society not to show the manipulated figures but to show a true and fair view of the company (Ochotorena, 2018). Even if the use of creative accounting is not always illegal it shows that managers which are under financial pressure look for solutions without obeying certain ethical standards. In other words, half-truths and lies may be considered susceptible to fraud. The ethical implication of Creative Accounting raises the need for a scrutiny of the potential abuse of accounting policy choice and manipulation of transactions. Despite many mechanisms to mitigate such unwanted practices in accounting reporting, it seems that we are still lacking effective tools and mechanisms specially to discipline the managers. Strengthening the corporate governance code conduct, continuous professional and leadership training at every level and so on, even though has positive impact on the quality of accounting reporting, there are always room for manipulation. We may not be able to limit the accounting choices to create the best solutions as we are also dealing with various and dynamic business environment, which require some flexibility in accounting choices. But maybe what we can also do is to think about how to build strong principles of good human being at every level.

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