INTERNATIONAL JOURNAL OF ACADEMIC RESEARCH IN ACCOUNTING, FINANCE AND MANAGEMENT SCIENCES

OPEN ACCESS JOURNAL

Vol 16, Issue 4, (2026) E-ISSN: 2225-8329

Creative Accounting in Large Corporations: Do Big Four Auditors and Corporate Governance Mechanisms Constrain Earnings Management or Change its Form?

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DOI Link: http://dx.doi.org/10.6007/IJARAFMS/v16-i4/29225

Published Online: 02 November 2026

Abstract

Creative accounting remains an enduring concern in corporate financial reporting despite significant improvements in accounting standards, audit regulation, corporate governance mechanisms, and financial disclosure requirements. The issue matters most for large corporations because they face substantial capital-market expectations, analyst scrutiny, executive compensation pressures, debt obligations, and reputational concerns that may incentivise managers to influence reported financial performance. Although large firms are generally subject to stronger governance structures and are more likely to engage Big Four auditors, the effectiveness of these monitoring mechanisms in eliminating creative accounting remains uncertain. This conceptual paper examines the relationship between firm size, corporate governance, Big Four audit quality, and three major forms of earnings management: accrual earnings management, real earnings management, and classification shifting. Drawing primarily on agency theory, positive accounting theory, and the substitution perspective of earnings management, the paper argues that stronger monitoring mechanisms may reduce conventional accrual manipulation without necessarily eliminating managerial opportunism. Instead, managers of large corporations may replace easily detectable accounting manipulation with less observable manipulation of real activities or classification shifts. We propose a conceptual framework in which firm size and managerial incentives shape creative accounting. At the same time, audit quality and corporate governance constrain certain forms of manipulation and also affect managers' choice of earnings-management technique. The paper contributes to the literature by shifting attention from whether governance and Big Four auditors reduce earnings management to whether they alter the composition of earnings-management strategies. The framework

provides several testable propositions and offers implications for auditors, boards, audit committees, regulators, investors, and future empirical research on large listed companies.

Keywords: Creative Accounting, Earnings Management, Big Four Auditors, Corporate Governance, Large Firms, Real Earnings Management, Accrual Earnings Management, Classification Shifting, Audit Quality

Introduction

Financial statements are expected to provide investors, creditors, regulators, employees, and other stakeholders with reliable information concerning an organisation's financial position and performance. However, financial reporting inevitably incorporates managerial judgement. Accounting standards permit managers to make decisions regarding provisions, estimates, impairment, revenue recognition, asset lives, inventory valuation, classification of expenditure, and numerous other accounting treatments. Although this discretion helps financial reporting reflect underlying economic conditions, it can also create opportunities to influence financial results strategically.

The broad concept of creative accounting encompasses accounting choices and reporting practices used to portray financial performance in a manner that benefits management or particular stakeholders without necessarily constituting outright accounting fraud. Contemporary academic literature primarily examines this phenomenon through the concept of earnings management. Earnings management occurs when managers exercise judgement in financial reporting or structure transactions to influence reported accounting outcomes, potentially affecting stakeholders' perceptions of firm performance (Healy & Wahlen, 1999).

Creative accounting is particularly relevant to large corporations. Large listed firms usually operate within complex organisational environments characterised by multiple business segments, sophisticated financial transactions, international operations, substantial intangible assets, complex revenue arrangements, numerous subsidiaries, and significant managerial discretion. At the same time, large corporations face intense scrutiny from institutional investors, analysts, financial media, regulators, creditors, and other capital-market participants. These competing characteristics create an important paradox. Large firms have sophisticated governance structures and external monitoring mechanisms that should theoretically reduce opportunistic reporting. However, they also face strong incentives to meet earnings targets and may have greater organisational capacity to use sophisticated earnings-management strategies.

Earnings management is no longer limited to manipulation of accounting accruals. Managers can influence reported performance through at least three broad mechanisms. First, accrual earnings management involves managerial discretion over accounting estimates, provisions, recognition policies, and other accrual-related decisions. Second, real earnings management involves altering actual operating activities, such as temporarily reducing discretionary expenditure, accelerating sales through discounts, or producing excessive inventory to reduce reported cost per unit. Managers alter real business activities to achieve financial-reporting objectives (Roychowdhury, 2006). More recent international literature demonstrates that real earnings management has become a significant concern because it may impose long-term economic costs on firms even when individual actions remain within accounting rules (Habib et al., 2022). Third, classification shifting occurs when managers

reclassify ordinary operating expenses as exceptional, special, or non-recurring items to improve measures such as core operating earnings without necessarily changing bottom-line net income (McVay, 2006).

The increasing sophistication of earnings-management techniques raises important questions regarding audit quality and corporate governance. Big Four audit firms, Deloitte, EY, KPMG, and PwC, are commonly used as proxies for higher audit quality because of their reputational capital, resources, expertise, methodologies, international networks, and litigation exposure (DeAngelo, 1981; Francis, 2004). Foundational evidence indicates that clients of higher-quality auditors exhibit lower levels of discretionary accruals (Becker et al., 1998). Nevertheless, evidence regarding the ability of Big Four auditors to constrain different forms of earnings management remains mixed.

For example, recent evidence indicates that Big Four auditors may constrain expense misclassification but may be less effective in preventing revenue-related classification shifting (Bansal, 2024). Other studies have similarly suggested that traditional audit-quality measures do not consistently reduce earnings management in all institutional settings (Chi et al., 2011). These findings imply that audit quality should be evaluated not merely by the total level of earnings management but by the type of earnings-management technique employed.

Corporate governance mechanisms present a similar challenge. Independent boards, effective audit committees, financial expertise, internal controls, and active monitoring are generally expected to constrain opportunistic reporting. Prior empirical evidence supports the role of board independence, audit committee activity, and financial sophistication in reducing discretionary accruals (Xie et al., 2003). Meta-analytic evidence also indicates that board and audit committee independence, expertise, audit firm size, auditor specialisation, and auditor tenure can reduce earnings management (Lin & Hwang, 2010). Nevertheless, corporate governance mechanisms may be better suited to detecting accounting-based manipulation than economically embedded operational decisions.

Indeed, audit committee financial expertise is associated with lower accrual earnings management but higher real earnings management (Cheung & Adelopo, 2022). This creates the possibility of a substitution effect. When managers face tighter constraints on one method of earnings management, they may switch to another method that is more difficult for auditors or boards to challenge.

The substitution argument is not new, and the contribution of this paper can only be judged against what prior research has already established. Three streams of evidence are relevant. The first examines trade-offs between accrual and real earnings management. Accrual-based earnings management declined and real earnings management increased after the Sarbanes-Oxley Act (Cohen et al., 2008), and analytical work shows that tightening accounting standards can produce the same displacement (Ewert & Wagenhofer, 2005). Zang (2012) further demonstrates that managers treat the two techniques as substitutes whose relative use depends on their respective costs, with real activities decided during the fiscal year and accruals adjusted after year-end to close any remaining gap. The second stream links this trade-off to monitoring intensity: higher audit quality (Chi et al., 2011) and audit committee financial expertise (Cheung & Adelopo, 2022; Xia et al., 2024) are associated with lower

accrual manipulation but greater use of real activities manipulation or alternative tactics. The third stream treats classification shifting as a further alternative. Managers move recurring expenses into special items to inflate core earnings (McVay, 2006; Fan et al., 2010), do so more when other earnings-management tools are constrained (Abernathy et al., 2014), and select among classification tools partly according to auditor type and firm size (Bansal, 2024). Table 1 compares these studies systematically.

Table 1
Comparison of prior substitution-based research and the present framework

Study	Techniques examined	Constraining force	Principal finding	Limit of the explanation
Ewert & Wagenhofer (2005)	Accounting vs real EM (analytical)	Tighter accounting standards	Tighter standards reduce accounting EM but increase real EM	Analytical model; auditors and boards not modelled; CS excluded
Cohen et al. (2008)	AEM, REM	Regulatory shock (Sarbanes-Oxley)	AEM declined and REM increased after SOX	Single regulatory event; firm-level monitoring not differentiated; CS excluded
Cohen & Zarowin (2010)	AEM, REM	Incentive setting (seasoned equity offerings)	Both techniques used; REM associated with more severe subsequent underperformance	Incentive-specific; monitoring is not the explanatory focus
Chi et al. (2011)	AEM, REM	External audit quality	Higher audit quality associated with greater REM	Auditor only; governance and CS not jointly modelled
Zang (2012)	AEM, REM	Relative costs of each technique	AEM and REM are sequential substitutes chosen on relative cost	Two-way trade-off; CS excluded; size not theorised as a condition
McVay (2006); Fan et al. (2010)	CS	Benchmark pressure	Expenses shifted into special items to inflate core earnings	Single technique; substitution not examined
Abernathy et al. (2014)	CS relative to AEM and REM	Constraints on other EM tools	CS increases when other EM tools are constrained	Constraint-based rather than monitoring-based; size not theorised
Cheung & Adelopo (2022); Xia et al. (2024)	AEM, REM / EM tactics	Audit committee financial expertise	Expertise lowers AEM but raises REM or alters tactic choice	Governance in isolation from external audit

Study	Techniques examined	Constraining force	Principal finding	Limit of the explanation
Bansal (2024)	CS (expense vs revenue misclassification)	Big Four, firm size, firm age	Big Four constrain expense but not revenue misclassification; large, mature firms favour revenue misclassification	Choice within CS only; AEM and REM not jointly considered
This paper	**AEM, REM, CS as one portfolio**	**Big Four audit quality and corporate governance jointly, conditioned by firm size**	**Proposes migration across all three techniques rather than uniform reduction**	**Conceptual; generates testable propositions (P1–P8)**

Note: AEM = accrual earnings management; REM = real earnings management; CS = classification shifting; EM = earnings management.

Read together, these studies establish that substitution occurs, but they leave three aspects underdeveloped. First, substitution is almost always examined pairwise, either accruals against real activities or accruals against classification, so the three techniques are rarely treated as a single portfolio from which managers choose. A decline in accruals that coincides with increased classification shifting would be invisible in an accrual–real design, and the reverse is equally true. Second, the constraining force is usually studied in isolation: a regulatory shock, auditor quality, or audit committee expertise. In practice, external audit and internal governance operate jointly and possess distinct monitoring domains, so the relevant question is not only whether a constraint triggers substitution but which constraint closes which channel. Third, firm size typically enters these studies as a control variable rather than as a theoretical condition. It is assumed to lower earnings management through visibility, not to shape the feasibility and cost of the alternatives towards which managers may move.

The present framework advances substitution-based explanations on each of these points. It treats accrual earnings management, real earnings management, and classification shifting as a three-technique portfolio, so that monitoring is evaluated by its effect on the composition of earnings management rather than on any single measure. It specifies differentiated, technique-specific effects for Big Four audit quality and corporate governance, recognising that monitors are strongest where manipulation passes through accounting estimates, whereas neither auditors nor boards can readily prohibit commercially defensible operating decisions or presentation choices. It formalises the distinction between earnings-management reduction and earnings-management migration, which earlier substitution studies imply but do not translate into testable propositions. Finally, it theorises firm size as a condition that governs substitution capacity, not merely the level of manipulation.

The focus on large corporations follows from this final point and offers theoretical, not merely contextual, insight. Substitution requires two conditions to hold simultaneously: a binding constraint on accrual manipulation and a feasible alternative. Large corporations are the

setting in which both conditions are most likely to be satisfied. On the constraint side, they are predominantly audited by Big Four firms, maintain formally independent boards and audit committees, and attract dense analyst and institutional scrutiny, which makes accrual manipulation comparatively costly. On the feasibility side, the scale of their discretionary expenditure, production, and customer arrangements allows real activities to be adjusted without conspicuous anomalies, while multiple segments, subsidiaries, and complex revenue streams widen discretion over income-statement classification (Bansal, 2024). Industry leadership may also lower the relative cost of real activities manipulation (Zang, 2012). Large corporations therefore constitute a critical case for the substitution perspective: if strong monitoring merely changes the form of earnings management, the change should be most visible where monitoring is strongest and alternative channels are most available. A further implication follows. Because Big Four engagement is close to universal among large listed firms, a Big Four indicator offers little variation in this segment, shifting the analytically relevant question from whether these firms are monitored to how monitoring reshapes their reporting choices. Pooled samples, in which audit quality and access to alternative channels both vary with size, tend to obscure this mechanism.

This paper therefore argues that the conventional question, "Do Big Four auditors and corporate governance reduce creative accounting?", is incomplete. The more important question may be: **Do stronger monitoring mechanisms eliminate creative accounting, or do they merely change the method through which managers engage in it?**

Based on this argument, the paper develops a conceptual framework integrating firm size, managerial incentives, Big Four audit quality, corporate governance effectiveness, and three alternative forms of earnings management. It makes three principal contributions. First, it extends substitution-based explanations from pairwise trade-offs to a three-technique portfolio, so that the effectiveness of monitoring is judged by the composition rather than the level of earnings management. Second, it specifies differentiated, technique-specific effects for external audit and internal governance and formalises the distinction between earnings-management reduction and earnings-management migration as testable propositions. Third, it repositions firm size from a control variable to a theoretical condition, arguing that large corporations constitute a critical case in which strong monitoring and substantial substitution capacity coexist (Cohen et al., 2008; Zang, 2012).

The framework is particularly relevant for listed corporations in emerging and developed markets and provides a foundation for future empirical research involving Bursa Malaysia or other major securities markets.

Literature Review

Creative Accounting and Earnings Management

Creative accounting refers to the strategic use of accounting discretion to achieve preferred financial reporting outcomes. Although terminology varies across studies, the concept overlaps substantially with earnings management, income smoothing, aggressive accounting, accounting manipulation, and financial-reporting discretion (Healy & Wahlen, 1999; Dechow & Skinner, 2000).

From an agency perspective, separation between ownership and management creates information asymmetry. Managers know more about the organisation's financial position and operational circumstances than outside shareholders. This informational advantage provides management with opportunities to exercise discretion in ways that may maximise managerial utility rather than shareholder wealth (Jensen & Meckling, 1976).

Managers may have numerous motivations to influence reported earnings. These include meeting analyst forecasts, avoiding losses, maintaining earnings-growth patterns, satisfying debt covenants, increasing performance-related compensation, supporting share prices, avoiding regulatory intervention, and protecting managerial reputation. These incentives may become especially important in large publicly traded corporations where quarterly and annual earnings results are intensively monitored (Burgstahler & Dichev, 1997; Graham et al., 2005).

Creative accounting should therefore be distinguished from straightforward fraud. Fraud involves intentional material misstatement or deception that violates legal or accounting requirements. Earnings management can occur within the technical boundaries of applicable accounting standards while nevertheless affecting the neutrality and economic representation of financial statements (Dechow & Skinner, 2000).

This distinction makes earnings management particularly challenging for auditors and regulators because many managerial choices cannot be classified simply as correct or incorrect. Instead, auditors must evaluate whether assumptions, estimates, transactions, and classifications reasonably reflect underlying economics.

Accrual Earnings Management

Accrual earnings management represents one of the most extensively studied forms of managerial reporting discretion. It involves adjusting accounting accruals rather than altering underlying business transactions. Examples include changing bad-debt provisions, warranty estimates, depreciation assumptions, asset impairment assessments, inventory allowances, revenue-recognition judgements, and provisions for future obligations. These decisions can accelerate or postpone the recognition of revenues or expenses and therefore influence reported earnings.

Discretionary accrual models are commonly employed in empirical research to estimate earnings management through accruals (Jones, 1991; Dechow et al., 2010). Researchers developed performance-matched discretionary accrual measures to improve on traditional approaches by controlling for firm performance, and this methodology remains influential in contemporary empirical earnings-management research (Kothari et al., 2005).

Accrual manipulation directly affects accounting recognition, putting external auditors in a strong position to scrutinise the underlying assumptions and supporting documentation behind these accounting treatments. Accordingly, higher audit quality is theoretically expected to constrain accrual-based earnings management.

Clients of higher-quality auditors exhibit lower discretionary accruals than clients audited by smaller audit firms (Becker et al., 1998). This suggests that large audit firms can constrain

aggressive accounting choices because of stronger reputational incentives and greater capacity to challenge management. However, reducing accrual manipulation does not necessarily remove managers' incentives to achieve targeted earnings outcomes. Managers may instead employ alternative methods.

Real Earnings Management

Real earnings management differs substantially from accrual manipulation because it involves actual operating decisions rather than simply accounting entries. Several major mechanisms through which managers may manipulate real activities have been identified, including offering temporary discounts to accelerate sales, overproducing inventory to reduce reported cost of goods sold per unit, and reducing discretionary expenditures such as advertising, research and development, training, or maintenance (Roychowdhury, 2006).

These actions can improve short-term accounting performance while reducing long-term corporate value. For example, cutting research and development expenditure may increase current-period earnings but weaken future innovation. Reducing employee training may improve current margins while undermining workforce capability. Excessive production may lower reported cost per unit but generate unnecessary inventory and storage costs. Survey evidence indicates that executives are willing to sacrifice long-term economic value to meet short-term earnings targets (Graham et al., 2005), and firms relying on real activities manipulation subsequently experience a more severe decline in operating performance than those relying on accruals (Cohen & Zarowin, 2010).

An extensive international review shows that auditing, governance, financial-reporting regulation, capital-market incentives, and other institutional variables influence real earnings management (Habib et al., 2022). Real earnings management creates difficulties for auditors because auditors generally possess authority to challenge inappropriate accounting treatments but cannot easily prohibit legitimate business decisions. If management reduces advertising expenditure or offers customers discounts, such decisions may fall within normal managerial authority even when the primary motivation is to influence earnings. This distinction suggests that organisations with stronger audit monitoring could exhibit lower accrual earnings management while maintaining or increasing real earnings management. Consistent with this reasoning, clients of higher-quality auditors have been found to engage in more real earnings management when accrual-based manipulation is constrained (Chi et al., 2011).

Classification Shifting

Classification shifting represents another important but comparatively less visible earnings-management strategy. Rather than changing total earnings, managers strategically classify revenues or expenses within the income statement.

Evidence documents that managers shift ordinary recurring expenses into special items to increase reported core earnings (McVay, 2006). Because analysts and investors often emphasise operating, or “core,” earnings and exclude exceptional items when assessing sustainable performance, classification shifts can significantly affect perceptions of corporate profitability even if bottom-line net income remains unchanged.

Later evidence confirms that classification shifting can be employed to achieve earnings benchmarks, particularly when other earnings-management mechanisms are constrained (Fan et al., 2010; Abernathy et al., 2014). An important dimension is added by evidence showing that large and mature firms may prefer revenue misclassification over expense misclassification, and that Big Four auditors constrain expense misclassification but do not appear equally effective in constraining revenue misclassification (Bansal, 2024). This evidence is highly relevant to large corporations because organisational complexity may confer on managers substantial classification discretion.

Firm Size and Creative Accounting

Firm size can influence earnings management through conflicting mechanisms. Under the monitoring perspective, larger firms face greater analyst coverage, institutional ownership, regulatory scrutiny, media attention, stronger internal control systems, and higher-quality external auditing. These factors should discourage aggressive reporting.

However, the complexity perspective suggests the opposite. Large corporations frequently have multiple operating segments, subsidiaries, geographic markets, sophisticated contracts, derivative instruments, intangible assets, and complex revenue streams. This complexity may increase managerial discretion and make financial-reporting judgements harder for external stakeholders to evaluate.

Large firms also face considerable pressure to satisfy capital-market expectations. Missing analyst forecasts or reporting earnings declines can trigger significant market reactions, potentially affecting executive compensation and reputation (Bartov et al., 2002; Skinner & Sloan, 2002).

The relationship between firm size and creative accounting is therefore unlikely to be linear. Large corporations may use fewer simple accrual manipulations while having greater ability to employ sophisticated techniques such as real earnings management and classification shifting.

Recent evidence supports this proposition, reporting that firm size affects the core earnings-management strategy managers select, with large and older firms particularly likely to favour revenue misclassification (Bansal, 2024).

Proposition 1: Firm size is associated with managers' choice of earnings-management technique, with large firms being more likely to employ sophisticated or less observable forms of creative accounting.

Big Four Audit Quality and Creative Accounting

Audit quality represents one of the principal external mechanisms intended to protect financial-reporting integrity. Big Four auditors possess significant technological resources, specialised personnel, global methodologies, sector expertise, and reputational capital. Large accounting firms also face substantial litigation and reputational costs if they fail to identify material financial misstatements (DeAngelo, 1981; Francis, 2004).

Clients audited by major audit firms exhibit lower levels of discretionary accruals (Becker et al., 1998). More broadly, meta-analytic evidence suggests that auditor size, tenure, and industry specialisation are negatively associated with earnings management (Lin & Hwang, 2010).

Nevertheless, Big Four status does not eliminate creative accounting. Audit effectiveness depends partly on whether the underlying behaviour falls within the auditor's traditional monitoring domain.

Auditors may be highly effective in evaluating provisions, accounting estimates, impairment tests, and recognition decisions because these directly affect financial statements. They may have considerably less influence over economically legitimate operating decisions such as production volumes, marketing expenditure, customer discounts, or business restructuring (Chi et al., 2011).

Recent evidence also indicates that Big Four auditors may constrain some classification-shifting techniques while failing to constrain others (Bansal, 2024).

Proposition 2: Big Four audit quality is negatively associated with accrual earnings management among large corporations.

However:
Proposition 3: The negative association between Big Four audit quality and real earnings management is weaker than its association with accrual earnings management.

Furthermore:
Proposition 4: Big Four audit quality constrains some forms of classification shifting more effectively than others.

Corporate Governance and Creative Accounting
Corporate governance mechanisms provide internal monitoring designed to align managerial decisions with shareholder interests. The board of directors and audit committee play a key role in overseeing financial reporting.

Financially sophisticated board and audit committee members are associated with lower discretionary accruals, and board and audit committee meeting frequency is similarly associated with reduced earnings management (Xie et al., 2003). Board and audit committee independence are likewise negatively associated with abnormal accruals (Klein, 2002).

Internal governance structures likewise support the conclusion that corporate governance arrangements are important in constraining managerial earnings manipulation (Davidson et al., 2005). In the Malaysian context specifically, corporate governance mechanisms have also been found to constrain earnings management, reinforcing the relevance of governance-based monitoring in this market (Katmon et al., 2022). Earlier Malaysian evidence, however, shows that governance effects are not uniform: larger boards were associated with more earnings management, whereas board and audit committee independence showed no significant constraining effect (Abdul Rahman & Ali, 2006). Evidence from other emerging

markets similarly confirms that corporate governance mechanisms constrain creative accounting practices, although effectiveness varies according to institutional context (Debbarma & Roy, 2023).

Meta-analytic evidence confirms that board independence, audit committee independence, financial expertise, audit committee size, meeting frequency, auditor tenure, auditor size, and auditor specialisation are associated with reduced earnings management (Lin & Hwang, 2010).

Nevertheless, governance effectiveness depends not merely on formal independence but also on expertise, authority, organisational status, and monitoring capacity. Audit committee financial expertise is particularly effective when combined with sufficient organisational status to challenge management (Badolato et al., 2014). The effectiveness of audit committee financial expertise may also depend on the gender composition of the committee, with evidence suggesting that female financial experts are associated with greater constraints on earnings management than their male counterparts (Zalata et al., 2018).

Recent research provides additional support for financial expertise but reveals an important unintended consequence: audit committee financial expertise reduces accrual earnings management but is positively associated with real earnings management (Cheung & Adelopo, 2022).

This observation supports a substitution explanation: managers may respond strategically when conventional accounting manipulation becomes more difficult.

Proposition 5: Stronger corporate governance reduces accrual earnings management in large corporations.

Proposition 6: Corporate governance effectiveness has a weaker constraining effect on real earnings management than on accrual earnings management.

Earnings-Management Substitution

The central argument of this paper concerns substitution among earnings-management techniques. Traditional research often conceptualises earnings management as a dependent variable that increases or decreases with governance quality. However, managers do not necessarily select a single earnings-management method independently of alternatives. Instead, they can choose among several strategies based on each technique's relative costs, detection risk, feasibility, and expected benefits (Zang, 2012).

If Big Four auditors increase scrutiny of discretionary accruals, accrual manipulation becomes relatively costly. Managers may therefore shift toward real business decisions. Similarly, if audit committees become highly proficient in identifying accrual irregularities, managers may increasingly use operational activities that are difficult for audit committees to distinguish from legitimate business strategy. Evidence from the United States documents such a shift following the Sarbanes-Oxley Act, as accrual-based earnings management declined while real earnings management increased (Cohen et al., 2008). Analytical modelling likewise shows that tighter accounting standards reduce accounting-based earnings management but can

increase real earnings management, which may, in turn, lower firm value (Ewert & Wagenhofer, 2005).

The finding of lower accrual manipulation but higher real manipulation in firms with financially sophisticated audit committees supports this perspective (Cheung & Adelopo, 2022). Consistent with the substitution perspective, post-regulatory evidence further indicates that audit committee financial expertise influences not only the level but also the specific tactic of earnings management that managers select (Xia et al., 2024).

The conceptual relationship can therefore be expressed as:
Strong Monitoring → Lower Accrual Manipulation → Increased Relative Attractiveness of Less Detectable Manipulation

Hence:
Proposition 7: Stronger audit quality and corporate governance encourage substitution from accrual earnings management toward real earnings management when managers retain strong incentives to achieve earnings targets.

Similarly:
Proposition 8: When accrual earnings management is strongly constrained, large corporations become more likely to use classification shifting to influence perceptions of core operating performance.

Theoretical Foundation
The proposed framework integrates agency theory, positive accounting theory, and the earnings-management substitution perspective. Agency theory explains why creative accounting occurs. Managers possess private information and may pursue objectives that differ from those of shareholders. Information asymmetry makes perfect monitoring impossible, creating opportunities for opportunistic reporting (Jensen & Meckling, 1976).

Positive accounting theory complements the agency explanation by identifying contractual incentives associated with accounting choices. Executive compensation arrangements, lending agreements, political considerations, and market expectations may influence managers' preferred accounting policies (Fields et al., 2001).

However, these theoretical perspectives alone do not fully explain why managers select one earnings-management technique instead of another. The substitution perspective addresses this limitation by treating earnings-management methods as alternative strategies.

Managers evaluate the expected costs and benefits associated with accrual manipulation, real activities manipulation, and classification shifting. Strong monitoring increases the expected detection cost of certain strategies (Zang, 2012). Consequently, management may choose less detectable techniques even when they impose greater economic costs on the organisation. Within large firms, this substitution process may become particularly sophisticated because managers possess organisational resources and multiple reporting opportunities.

Methodology

This study adopts a conceptual research design based on an integrative review and theoretical synthesis of earnings-management, audit-quality, corporate-governance, and creative-accounting literature. The study does not attempt to estimate empirical relationships using fabricated or secondary numerical results. Instead, it integrates peer-reviewed journal literature to develop theoretical propositions that can be tested empirically.

The conceptual synthesis focuses on four major streams of research: accrual earnings management, real earnings management, classification shifting, and monitoring mechanisms. Particular attention is given to research examining Big Four or large audit firms, audit committee effectiveness, corporate-governance characteristics, and firm size.

Agency theory is used to explain managerial incentives and information asymmetry. The audit-quality and corporate-governance literature explains monitoring mechanisms, while the substitution perspective explains managers' selection among alternative earnings-management techniques.

Based on this synthesis, the proposed model positions firm size and managerial reporting incentives as major antecedents of creative accounting. Big Four audit quality and corporate-governance effectiveness serve as monitoring mechanisms that constrain managerial discretion. However, rather than assuming that monitoring uniformly reduces all earnings-management techniques, the framework proposes differentiated effects across accrual earnings management, real earnings management, and classification shifting.

The framework therefore generates theoretically testable propositions suitable for subsequent quantitative analysis. Section 5 sets out these conceptual findings and the proposed framework; Section 6 discusses their implications for theory and practice.

Results and Findings

Conceptual Findings

The literature reviewed in this paper suggests that the relationship between creative accounting and corporate monitoring is considerably more complex than traditionally portrayed. The first conceptual finding concerns the multidimensional nature of creative accounting. Accrual manipulation, real activities manipulation, and classification shifting are not interchangeable accounting behaviours. Each technique operates through different mechanisms and therefore presents different monitoring challenges.

The second conceptual finding is that large firms should not automatically be considered less susceptible to creative accounting merely because they possess stronger corporate governance mechanisms. Firm size increases visibility and external monitoring, but it also increases organisational complexity and pressure to maintain market performance. Consequently, the form, rather than merely the magnitude, of creative accounting may vary with firm size.

The third conceptual finding concerns the selective effectiveness of Big Four auditors. High-quality auditors possess a substantial capacity to scrutinise accounting estimates and financial reporting decisions. Their effectiveness is therefore expected to be strongest against

accrual earnings management. In contrast, real earnings management occurs through operational decisions that auditors cannot easily challenge if the transactions themselves are legitimate.

Fourth, corporate governance mechanisms may exhibit similar limitations. Audit committees with significant accounting expertise may effectively recognise abnormal accruals. However, sophisticated managers can respond by manipulating operating decisions that appear commercially defensible. The fifth and most important conceptual finding is therefore the existence of a potential earnings-management substitution effect.

Proposed Framework

Figure 1 presents the proposed conceptual framework illustrating the relationships between large firm characteristics, managerial incentives, corporate governance effectiveness, Big Four audit quality, and the selection of creative accounting techniques. The framework proposes that large firms operate within complex financial reporting environments characterised by growth opportunities, executive compensation arrangements, analyst and investor scrutiny, contractual obligations, and managerial reputational concerns. These characteristics may create incentives for managers to achieve specific financial reporting targets, including meeting analysts' forecasts, avoiding reported losses or earnings declines, and satisfying capital market expectations. Consequently, managers may engage in different earnings management techniques to influence reported financial performance.

The framework identifies three principal techniques through which managers may exercise discretion over reported earnings: accrual earnings management, real earnings management, and classification shifting. Accrual earnings management involves the manipulation of accounting estimates, discretionary accruals, revenue recognition policies, and provisions within the boundaries of financial reporting practices. Real earnings management, in contrast, involves adjustments to actual operating activities, such as offering sales discounts, increasing production to reduce reported cost of goods sold, reducing discretionary expenditures, and altering the timing of business transactions. Classification shifting refers to the strategic reclassification of income statement items, particularly between recurring operating expenses and special or non-operating items, to influence the presentation of core earnings without necessarily changing total reported net income.

Corporate governance effectiveness and Big Four audit quality are incorporated into the framework as monitoring mechanisms that may constrain opportunistic financial reporting behaviour. Corporate governance effectiveness is reflected in board independence, audit committee expertise and independence, audit committee diligence, and internal control quality. Meanwhile, Big Four audit quality is represented by the engagement of a Big Four audit firm, auditor industry expertise, auditor tenure, and audit effort. Collectively, these mechanisms are expected to strengthen financial reporting oversight, enhance accountability, and reduce managerial discretion in preparing and presenting financial statements.

Nevertheless, the framework suggests that these monitoring mechanisms may be more effective for some earnings management techniques than others. Stronger corporate governance and higher audit quality are expected to constrain accrual earnings management

more because financial reporting reviews and external audits directly examine accounting estimates, recognition decisions, and supporting documentation. In comparison, real earnings management and classification shifting may be less responsive to conventional monitoring mechanisms, given that they involve operational decisions and financial statement presentation choices that can be more difficult to distinguish from legitimate managerial judgement.

Furthermore, persistent managerial incentives to meet financial reporting targets may shape the choice of earnings management techniques as monitoring mechanisms become more effective. Specifically, greater restrictions on accrual manipulation may increase the relative attractiveness of real earnings management and classification shifting as alternative methods of influencing reported financial performance. This possibility introduces an important conceptual distinction between earnings management reduction, whereby stronger monitoring decreases the overall extent of opportunistic reporting behaviour, and earnings management migration, whereby managers respond to increased scrutiny by shifting towards alternative earnings management techniques.

Accordingly, the proposed framework suggests that the effectiveness of corporate governance and Big Four audit quality should be evaluated not only in terms of their ability to constrain individual earnings management techniques but also in relation to their potential influence on managerial choices across different techniques. This perspective offers a more comprehensive view of how managerial incentives, monitoring effectiveness, and financial reporting behaviour interact in large firms. It also establishes a theoretical foundation for future empirical investigations into whether stronger monitoring mechanisms reduce overall earnings manipulation or unintentionally encourage substitution among creative accounting techniques.

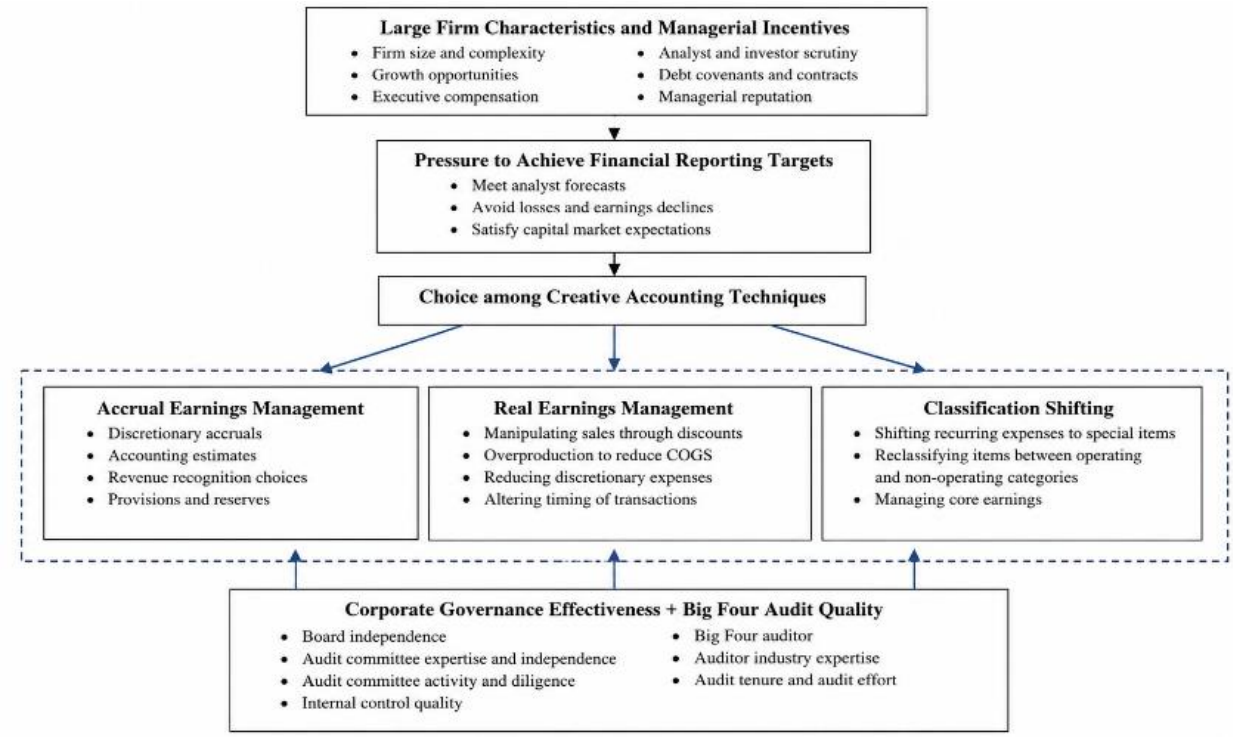


Figure 1 Proposed Framework

Discussion of Findings

The conceptual framework challenges the assumption that a sophisticated audit committee or a Big Four auditor engagement is sufficient evidence of high-quality financial reporting. A company could report relatively low discretionary accruals while simultaneously engaging in extensive real activities manipulation. An auditor evaluating traditional accounting entries may therefore conclude that financial statements are technically compliant even though management has sacrificed economically valuable expenditure to achieve accounting targets.

For example, a large corporation facing pressure to meet annual earnings forecasts may initially consider increasing reported earnings through optimistic provisions or accounting estimates. A strong external auditor may challenge those assumptions. Management may then respond by cutting advertising, postponing maintenance, freezing employee development spending, accelerating sales through discounts, or delaying strategic spending. As a result, the accounting statements may show fewer questionable accruals, while earnings quality remains problematic.

A similar problem applies to classification shifting. Management may present restructuring expenses, impairment charges, or other expenditures outside core operating results. Although net income may remain unchanged, investors focused on adjusted earnings or operating profit may get an overly favourable impression of recurring performance. This issue matters especially for large corporations because analyst forecasts and market expectations can create substantial pressure to show smooth, consistent performance.

The framework also raises questions regarding audit-quality measurement. Many empirical studies use a Big Four dummy variable where firms audited by Deloitte, EY, KPMG, or PwC receive a value of one. Although useful, this approach may oversimplify actual audit quality. Audit outcomes could differ according to industry expertise, engagement-partner experience, audit tenure, audit fees, non-audit services, office characteristics, client importance, and audit committee interactions.

Future studies should therefore consider multidimensional measurements of audit quality. Similarly, formal corporate-governance compliance may not necessarily indicate substantive monitoring effectiveness. An independent audit committee that lacks financial-reporting knowledge, organisational authority, time commitment, or access to information may be less effective than its formal composition suggests. Research demonstrating the importance of both expertise and status supports this argument (Badolato et al., 2014). The paper consequently proposes moving beyond a compliance-oriented understanding of governance toward a capability-oriented perspective.

Conclusions and Recommendations

Conclusions

Creative accounting remains relevant despite decades of improvements in accounting regulation, corporate governance, audit methodologies, and financial disclosure. The problem persists partly because managerial behaviour is adaptive. Managers confronted with restrictions on one method of manipulating financial performance may employ another method that is less observable or less easily challenged.

This conceptual paper proposes that creative accounting in large corporations should therefore be examined as a portfolio of alternative reporting strategies rather than as a single homogeneous practice. Large corporations present a particularly important context. They generally face stronger external auditing and more sophisticated corporate governance, yet they also face substantial capital-market expectations and possess organisational complexity that may facilitate sophisticated financial reporting strategies.

The literature indicates that Big Four auditors and strong corporate-governance mechanisms can reduce conventional accrual manipulation. However, emerging evidence suggests that these monitoring arrangements may be considerably less effective against real earnings management and certain forms of classification shifting.

Accordingly, the central proposition of this paper is that improved monitoring may sometimes produce earnings-management migration rather than complete earnings-management elimination. This perspective has implications for theory, research, audit practice, corporate governance, and regulation. Researchers should investigate multiple earnings-management techniques simultaneously. Auditors and audit committees should broaden their monitoring activities beyond technical accounting compliance. Investors should consider operational and classification-based indicators alongside accrual measures. Regulators should recognise that increasingly restrictive financial-reporting rules may alter rather than eliminate managerial incentives.

Ultimately, financial-reporting quality should not be evaluated solely on whether managers technically comply with accounting standards. Greater attention must be given to whether accounting outcomes faithfully represent the organisation's economic performance. Understanding how managers adapt their creative-accounting strategies when confronted with sophisticated governance and Big Four auditing represents an important direction for future accounting research.

Implications

The conceptual model has significant implications for several stakeholders. For external auditors, the findings suggest expanding audit procedures beyond detecting aggressive accrual assumptions. Analytical procedures that can identify abnormal operational patterns may help auditors assess whether management has manipulated actual activities. Unexpected reductions in discretionary expenditure, unusual production growth, abnormal inventory accumulation, unusually generous customer discounts, or unexplained changes in operating cash-flow relationships may warrant additional investigation.

For audit committees, financial expertise remains important, but committee members should avoid concentrating exclusively on technical accounting entries. Audit committees should question the economic rationale underlying unusual operational decisions occurring near financial year-end.

On the other hand, boards of directors should not automatically interpret persistent achievement of earnings targets as superior management performance. Boards should evaluate whether reported results have been achieved through economically sustainable activities.

Further, the framework suggests that low discretionary accruals do not necessarily indicate the absence of earnings management for institutional investors and financial analysts. Consider cash flows, production behaviour, discretionary expenditure, non-recurring items, adjusted earnings, and segment performance jointly.

For regulators and accounting standard setters, the framework illustrates the limits of increasingly detailed accounting rules. Restricting one accounting treatment can generate incentives for managers to employ alternatives outside the direct boundaries of accounting standards (Ewert & Wagenhofer, 2005).

Recommendations for Future Empirical Research

The conceptual framework is particularly suitable for empirical testing using large listed firms. A future study could examine companies listed on Bursa Malaysia's Main Market over a period such as 2015–2025. Financial institutions could initially be excluded because their accrual processes and regulatory requirements differ substantially from those of non-financial corporations.

Firm size could be measured using the natural logarithm of total assets, market capitalisation, or revenue. Besides, accrual earnings management could be estimated using performance-matched discretionary accruals (Kothari et al., 2005). Real earnings management could be measured using abnormal operating cash flow, abnormal production costs, and abnormal discretionary expenditure (Roychowdhury, 2006). In addition, classification shifting could be estimated by examining unexpected core earnings and the classification of special or non-recurring items (McVay, 2006).

Big Four audit quality could initially be measured using a binary indicator and subsequently supplemented with auditor tenure, industry specialisation, and audit fees. Corporate governance variables could include board independence, board financial expertise, audit committee independence, audit committee accounting expertise, meeting frequency, gender diversity, CEO duality, and institutional ownership.

An especially interesting empirical contribution would be to test whether increases in real earnings management accompany reductions in accrual earnings management associated with Big Four auditors. Such evidence would directly test the substitution hypothesis proposed in this paper.

A related model could test interactions between firm size and Big Four audit quality:
Creative Accounting = f(Firm Size, Big Four Auditor, Corporate Governance, Managerial Incentives, Controls)

Separate regressions should then be conducted for accrual earnings management, real earnings management, and classification shifting.

A particularly novel hypothesis would be that Big Four auditors reduce accrual earnings management more strongly among large corporations. However, Big Four-audited large firms exhibit a greater tendency to substitute real earnings management for accrual manipulation

when capital-market pressure is high. Testing this proposition could make a meaningful contribution to contemporary audit and corporate-governance research.

Acknowledgement
The authors gratefully acknowledge the National Defence University of Malaysia (Universiti Pertahanan Nasional Malaysia, UPNM) for the financial support that made this research possible.

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