THE CHALLENGES OF CREATIVE ACCOUNTING IN NIGERIA

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ABSTRACT

The study looked at the concept of creative accounting and the various senses the term is occasionally used. It noted that issues of finance are all involving and too complex to have only one set of watertight rules governing it. As a result, accounting standards provided alternative methods of treading some items. Sometimes, some corporate organizations go beyond the flexibility limits allowed by the accounting profession, in order to achieve some pre-determined results. This marks the point of departure. While some accountants and financial analysts see the practice as good, depending on application, others believe it is entirely distructive. In the light of the above, the study looked at the ways through which creative accounting is perpetrated in organizations and common reasons for such practice. Furthermore, the ethical implications of creative accounting were discussed against the background of some accounting principles and concepts. The study concluded that creative accounting has become one of the emerging problems of the accountancy profession and therefore requires concerted effort to stem the tide. Finally, the authors recommended, among other things the introduction of forensic accounting in the country to check the increasing incidence of creative accounting.

INTRODUCTION

Generally speaking, professionals are regulated, in one way or the other, by sets of rules, which start from the conduct of the activities of the profession to the behaviour of members. While some professions are lightly regulated, others regulated heavily. The nature or business of professions goes a long way in determining how it should be regulated.

Accounting profession happens to be one of such professions that are strictly regulated. To that effect, preparation and presentation of financial statements of corporate bodies are bound by laws and accounting standards. To break these is an offence an it is enforced as such. Judges enforce the letter of the law and where there are loopholes, the law may be changed (Study world 2008).

However, issues of finance are all involving and too complex to have a set of watertight rules governing it. (Study world 2008) hence, accounting standards provide alternative methods of treating some items. For instance, SAS 4 and SAS 22 provide different methods for stock valuation and treatment of goodwill respectively.

It therefore follows that many companies deliberately choose methods of accounting that tend to give their companies the best competitive advantage in their industry. Sometimes, companies go beyond the rules of the accounting profession in order to positively and consistently project their companies to the unsuspecting investors under a relatively new terminology called creative accounting.

Some accountants and financial analysts see creative accounting as a good financial instrument capable of producing positive or negative results while others see it, only as a destructive weapon that must be eliminated from the accounting profession. Consequent upon the above, it becomes absolutely necessary to x-ray the term creative accounting with a view to understanding its ethical implications.

This paper shall therefore, discuss the topic under the following sub-headings: concepts of creative accounting; methods, reasons, accounting scandals perpetrated, ethical implications, recommendations and conclusion.

THE CONCEPT OF CREATIVE ACCOUNTING

The term creative accounting was first used in 1968 in the film, 'The producers' by Mel Brooks (Ehrenstein 2006). Since then, it has continued to be used in two major senses namely (1) a version suggestion a blessing and (2) another version implying a curse (Harry 2002).

It is seen as a blessing when a new accounting technique is introduced to refine the accounting system and therefore becomes an addition to the existing stock of accounting knowledge. It becomes a curse when unethical elements make intrusion.

It is in strict association of the term to the two versions mentioned above that creative accounting is sometimes called innovative or aggressive accounting on one hand and deceptive accounting on the other hand. It is innovative or aggressive accounting when it is a blessing and deceptive accounting when it is a curse. But recently, situations tend to show that creative accounting practice is, in most cases, a curse rather than a blessing, and therefore undesirable.

Four authors in the United Kingdom, each writing from a different perspective have explored the issue of creative accounting.

Griffiths (1992), writing from the perspective of a business journalist, observes:

Every Company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures, which are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse - - -. Infact, this deception is all in a perfectly good taste. It is totally legitimate. It is creative accounting.

The author sees creative accounting as a deliberate "cooking or roasting" of the financial books with a view to suppressing actual financial results. He believes it is entered into by companies to achieve some defined objectives, within some allowable limits.

However, Jameson (1988), writing from the perspective of the accountant, argues:

The accounting process consists of dealing with many matters of judgment and of resolving conflicts between competing approaches to the presentation of the results of financial events and transactions - - - - this flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities practiced by the less scrupulous elements of the accounting profession have come to be known as creative accounting.

The author argues that accountants exercise a wide range of judgment in the choice of methods of presentation of results of financial transactions and this flexibility creates opportunities for manipulation, deceit and misrepresentation. In view of this, accountants choose methods of presentation that would help them attain certain objectives as well as given them an edge over their competitors.

Smith (1992), shares his views as an investment analyst on the subject matter thus:

We felt that much of the apparent growth in profits which had occurred in the 1980s was the result of accounting sleight of hand rather than genuine economic growth, and we set out to expose the main techniques involved, and to give live examples of companies using those techniques.

This author was basically concerned with reported company profits that occurred in the 1980s. He observed that growths in company profits in the years under review were not real growths due to favourable business conditions, but as a result of manipulations by accountants of companies purposely to give an impression of steady profit growth. He noted that companies involved in such manipulations rarely gave dividends to their shareholders. This could be a strategy to avoid distribution of their companies' capital as dividends.

Naser (1993), writing from an academic background defined creative accounting as "the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them". He attributed the manipulations to freedom of choice allowed by the accounting practice.

Naser's definition hinges on two basic issues. The first is the transformation of financial accounting figures from actual results to what the preparers desire. This implies a pre-determined resolved, by the management of the involved company whose responsibility it is to prepare the accounts, to report the outcome of their financial transactions in a particular pattern irrespective of actual results. The second is that the preparers take advantage of the existing rules and/or ignoring some or all of them. This suggests that the preparers of the accounts know the rules and they apply such knowledge in the choice of accounting methods that will assist them achieve their objectives. They (preparers) also decide to ignore some or all rules they consider impediments to the achievement of pre-determined financial results. The second issue obviously is of ethical concern to accountants and all users of financial reports.

Wikipedia (2003) states that creative accounting is euphemism referring to accounting practices that may or may not follow the letter of the rules of standard accounting practices but certainly deviates from the spirit of those rules. It is characterized by excessive complication and the use of novel ways to characterize assets and /or liabilities.

Walton (1996) sees creative accounting as the aggressive use of choices available under accounting rules, to present the most flattering view of a company in its financial statements. It involves pushing accounting principles to the limits of their flexibility (or even beyond) in order to improve their statements. It is note worthy that Walton's views appear polite. However it is certain that application of accounting principles beyond the limits of their flexibility implies direct violation of those principles.

Many understand creative accounting as a systematic misrepresentation of the true assets and liabilities of corporations or other organizations. Consequent on the above, it is believed that creative accounting is at the root of a number of shocking accounting scandals all over the world. This assertion is not far from the truth as shown by the following reported cases across the world.

SOME ACCOUNTING SCANDALS ATTRIBUTED TO CREATIVE ACCOUNTING

(1) THE ENRON CASE

Enron was an American Energy giant that came into existence in July 1985 through the merger of Houston Natural Gas and Inter North under Kenneth Lay as the Chief Executive Office of the company.

With an asset base in excess of $64 billion, Enron diversified from an energy producer to an energy trader in metal, coal, pulp and paper and other derivatives. As a result of its business diversification, Enron's status changed from an inter state natural gas pipeline company to a global marketer and trader of oil, gas, electric energy and associated derivatives.

By the year 2000, Jeffrey Skilling rose the position of Chief Executive Officer and Ken Lay became the Chairman. During that time the company rose to its peak with its stock soaring between $91 and $100 per share in the stock exchange market. As the company was basking under the euphoria of its success, it made the largest corporate donation of $133,800 to George Bush 2000 electioneering campaign (Walton, 1996).

Arthur Anderson worked concurrently as auditor and financial consultant to Enron and earned huge amounts of money from these two assignments. For instance, Anderson earned $25 million from audit and $27 million from consultancy.

Two executives of Enron had previously worked for Anderson Enron formed Special Purpose Entities (SPE) otherwise known as partnership with former executives of Enron, who profited greatly from the venture.

Shortly after Enron's diversification, the new projects recorded a loss of $500 million and Enron also sustained a loss of $500 million as a result of California energy crisis. As a result of those losses, Enron procured several loans from the debt market to keep its operations running. Those loans were kept off Enron's balance sheet under the cover of creative accounting policies. Enron employed several techniques including reduction of its equity interest by $1.2 billion to overstate its profits and under report its debts in a desperate attempt to keep the company financially afloat. Worse still, Enron reported $618 million loss for the third quarter of 2001 and that huge loss stimulated the interest of United States Security and Exchange Commission to institute an inquiry into the activities of Enron in November, 2001. it was revealed that Enron's profits were over stated by $586 million in the last five years yet Arthur Anderson consistently certified its financial statements as adequate. Overwhelmed with liquidity problems, Enron, the US Energy giant filed for bankruptcy, the biggest in American history, in December 2001. (Wikipedia, 2003).

The auditing firm was finally convicted of a criminal charge of obstructing justice in June, 2003 and it consequently lost its licence to practice in Texas in August, 2003.

(2) THE CASE OF FERRANTI INTERNATIONAL SIGNAL AND ITS SUBSIDIARY, INTERNATIONAL SIGNAL CONTROL (ISC) TECHNOLOGIES

Ferranti International acquired ISC Technologies in September 1987 for £420 million sterling based on accounts that were audited by Peat Marwick Mclintock, who were unaware of an alleged fraud of £215 million sterling in the company. The fraud involved three non-existent arms deals in Pakistan, China and Nigeria, through payments made to a network of companies in Panama and Switzerland who, purportedly, were sub-contractors to the deals. Some of the money was recycled to the company's United States subsidiary as if the contracts were real. The effect of this was to inflate the assets and profits of the subsidiary, which as a result, showed a net worth of US$320 million, whereas the company has absolutely no net worth. Ferranti International suffered because it paid £420 million sterling to acquire a company that was worthless at the time of acquisition (Sen and Inanga 2006). In other words, Ferranti International paid £420 million sterling to acquire net assets that did not exist but were rather "cooked" and presented.

(3) THE WORLDCOM INCORPORATED CASE

In 1995, Long Distance Discount Services (LDDS) acquired Williams Telecommunications Group Incorporated (WITEL) for $2.5 billion and subsequently changed its name to WorldCom Incorporated with Bernard Ebbers as the CEO. Sequel to the acquisition, WorldCom became one of the leading telecommunication giants in USA (Investopedia 2000).

In 1998, WorldCom acquired MCI Communications, a company that has more than two-and-a-half times the capital base of WorldCom. What was WorldCom's financial trick for that feat? Its financial mystery was embedded in creative accounting. He had also concluded an arrangement for a merger with

Sprint in early 2000 when US and European governments forced it to abandon the proposal as a result of antitrust objectives.

An organized inquiry into the activities of WorldCom in June 2002 revealed a staggering accounting fraud of $11 billion perpetrated through a combination of the some of following accounting manoeuvres:

(a) Over-Stating its profits from early 1999 through the first quarter of 2002.

(b) Capitalizing operating expenses.

In fact, $3.8 billion worth of normal operating expenses, which should have been recorded as expenses for the accounting year were actually incurred were treated as investments, and therefore recorded over a number of years. That manoeuvre grossly exaggerated the company's profit for the year the expenses were incurred. In fact, in 2001, WorldCom reported a profit of about $1.3 billion when it should have reported loss (Theodore Stefano 2005).

Consequent on the above, the U.S Security and Exchange Commission (SEC) filed and won a legal battle against WorldCom in November 2002. Subsequently, Bernard Ebbers, the Chief Executive Officer of WorldCom was convicted of orchestrating the US $11 billion accounting fraud in the company and was sentenced to 25 years in prison in July 13, 2005 (Tom, 2005).

METHODS OF CREATIVE ACCOUNTING

Whichever form creative accounting presents, it usually falls into any of the following methods.

(1) **Situations of Unavoidable Degree of Estimation, Judgment and Prediction**

Certain entries in accounts involve unavoidable degree of estimation, judgement and prediction by the accountants. Relevant accounting principles enjoin accountants to be conservative in this respect. However, the fact remains that the accountant has the right to make certain estimations, judgements and predictions in the course of his professional duties. The extent he does this is only a matter of conscience. Examples of these situations include, estimation of an asset's useful life in order to calculate depreciation, judgement in making provisions for bad and doubtful debts and in predicting the likely outcome of legal battle involving the company. (Dahi, 1996).

An accountant interested in creativity sees the above as an opportunity to manipulate his estimates, judgements and predictions to produce a pre-determined business results.

(2) Slush Fund Accounting: This is a system where some earnings from one good quarter are hidden away just in case the profit from another quarter is not enough for the management to make their bonuses (Wikipedia, 2008). This method runs counter to the provisions of disclosure requirements. Some accountants use this system to manipulate financial records of corporations and organizations.

(3) Artificial Transactions: This can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. It is achieved by entering into two or more related transactions with an obliging third party, normally a bank (Amat, Blake and Dowds 1999). For example, an arrangement could be made to sell an asset to a bank, then lease that asset back for the rest of its useful life. The sale price under such a 'sale and lease back' can be recorded above or below the current value of the asset because the difference can be compensated for by increased or reduced rentals. Artificial transactions can also be arranged with subsidiaries of companies with profits from sale of assets to subsidiaries recorded at profit in parent company's books when in actual fact no sale or profit was made.

(4) Genuine Transactions: This can be timed so as to give the desired impression in the accounts (Amat, Blake and Dowds, 1999). For instance, the manager of business with an investment of N1 million at historic cost, which can easily be sold for N3 million being the current value, may choose in which year to sell the investment in order to increase their profit in the accounts.

(5) Selective Treatment of Exceptional Items

Many corporations pick and choose when to disclose exceptional items. For instance, many companies exclude one time charges and other exceptional liabilities from their annual reports while they add income from exceptional activities to their profits (Wikipedia, 2007). Through this method, they manipulate financial results of their companies.

(6) Choice/Change of Accounting Methods: Sometimes, the accounting rules allow a company to choose between different accounting methods or to change from one accounting method to another. Amat, Blake and Dowds (1999)opine that some companies therefore choose methods that will boost the result of their business activities and give them preferred image. An example is in the choice of method of treatng depreciation, and research and development costs.

(7) Difference in Corporation and Personal Tax Rates:

Wilipedia 2007 stated that small companies, especially in advanced countries, use creative accounting through this method, for tax saving purposes. They include salaries of proprietors in business profits to benefit from corporation tax rates when they are lower than personal tax rates. Again, spouses of proprietors are sometimes included as employees, though they may never have worked for the company in order to have some tax savings.

REASONS FOR CREATIVE ACCOUNTING

Different reasons have been adduced for involvement of companies in creative accounting strategies. But Amat, Blake and Dowds (1999) state that reasons frequently given for the directors of listed companies to seek to manipulate the accounts of their companies include:

(1) Income Smoothing: Companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with series of dramatic rises and falls. This is achieved by making unnecessarily high provisions for liabilities and asset values in good years so that these provisions can be reduced, thereby improving reported profits in bad years.

They observed that advocates of this approach argue it is a measure against short-termism' of judging an investment on the basis of its yields in a particularly good year. It also avoids raising expectations so high in good years that the company is unable to deliver subsequently.

On the other hand, it is argued that if the trading conditions of a business are in fact volatile, the investors have a right to know that income smoothing may conceal long-term changes in the profit trend.

(2) Profits to Follow Forecasts: It is argued that companies manipulate profits in order to follow forecasts. Fox (1997) reports on how accounting policies at Microsoft are designed, within the normal accounting rules, to match reported earnings to profit forecasts. When Microsoft sells software, a large part of the profit is deferred to future years to cover potential upgrade and customer support costs. Microsoft was able to use the method to ensure reasonable accuracy in the prediction of future earning.

(3) To maintain or boost share price of companies: Creative accounting may be used to maintain or boost the share price of companies both by reducing the apparent levels of borrowing, so making the company appear subject to less risk, and by creating the appearance of a good profit trend. This helps the company to raise capital from share issues, offer their own shares in takeover bids and resist takeover by other companies.

(4) To aid 'insider dealing' in company shares: Directors that engage in 'insider dealing' in their company's share can use creative accounting to delay the release of information for the stock exchange market, thereby enhancing their opportunity to benefit from inside knowledge.

In another development, Dharan and Lev (1993) opine that the following set of reasons for creative accounting, which applies to all companies, arises because companies are subject to various forms of contractual rights, obligations and constraints based on the amounts reported in the accounts:

(a) Desire not to exceed loan limit:

It is common for loan agreements to include a restriction on the total amount of loan a company is entitled to borrow computed as a multiple of the total share capital and reserves. Therefore, when a company's borrowings are near this limit, its directors may engage in creative accounting to increase its reported profit and consequently the reserves to enable it continue to have access to more loans (Sweeney, 1994).

(b) To increase director's bonus:

When directors' bonus scheme is linked to reported profits or to the company's share price, the directors tend to manipulate reported profits or share price through creative accounting to boost their bonuses.

(c) To comply with regulator directives:

Some public utilities like electricity and telephone companies are usually subject to the authority of a government regulator who prescribes the maximum amounts they can charge. If such companies report high profits, then the regulator is likely to respond by reducing their charges. The directors of these companies, therefore, choose accounting methods that tend to reduce their reported profits.

(d) To reduce tax liability: Usually, company tax is a percentage of reported profits. Some company directors who do not want to pay their actual tax obligation resort to creative accounting to reduce their reported profit and consequently their tax liability.

IMPLICATIONS OF CREATIVE ACCOUNTING

Whenever creative accounting occurs, some users of accounting information suffer some disadvantage. Leung and Cooper (1995) note that creative accounting puts one group or two to advantageous position at the expense of others' interest. For instance, management's interest is to have more bonuses and pay less tax and dividend; shareholders interest is to get more dividends and capital gains; tax authorities would like to collect more tax while employees are interested to get better salary.

The implications of creative accounting will be discussed under the following sub-headings:

(1) Effect on the going concern of the corporation: One of the assumptions in accounting is that every business entity is a going concern. But the practice of creative accounting threatens this. Smith (1992) observes that distortion of financial records in one year often increases the need to distort in subsequent years. The company therefore gets more tied into misleading figures and often devotes more time to presentation of figures rather than management of the company which results in an inevitable collapse. (Alam and Sahabub, 1988).

(2) **Lack of trust on accounting reports**

Financial statements of companies are of great relevance to a number of people such as employees, investors, tax authorities, financial analysts, regulators, etc for various decision-making purposes. If these statements can be boosted or manipulated just by a stroke of an accountant's pen, then basis of reliability on such reports will become eroded; thereby resulting in lack of trust (Revsine, 1991).

(3) **Hoarding of information:**

Fatt and Teng (1995) note that creative accounting often involves hoarding of useful information from one group or the other. It is either the shareholders are denied of the opportunity to know how their corporation has faired or the tax authorities are not told the real profit of the company. Sometimes, prospective investors could be deceived into investing in an unprofitable venture through incomplete disclosure methods often involved in creative accounting.

(4) **Violation of accounting rules:**

When fraudulent reporting occurs, it is frequently perpetrated at high levels of management and it involves the use of financial statements to create an illusion that the entity is healthier and more prosperous than it actually is. This illusion is often accomplished by masking economic realities through intentional misapplication of accounting blatant violation of accounting rules principles (Conner, 1986). It is necessary to note that blatant violation of accounting rules shakes the foundation of accountancy profession and subjects its reports to public ridicule.

CONCLUSION

Creative accounting has become one of the emerging problems of the accounting profession and therefore, offers a formidable challenge to the practice of the profession. It is not limited to developing countries; instead, it cuts across the entire countries of the world.

The most agonizing effect of this ugly practice is its root in the violation of basic accounting rules, which is the pivot upon which accountancy profession rotates. It is in view of the above that all accountants in particular, and users of accounting information in general, should be concerned about how to stamp out or at least minimize the incidence of creative accounting in the world.

RECOMMENDATIONS

The authors believe that all hope is not lost for the accountancy profession. They therefore make the following recommendations to curb the increasing rate of creative accounting:

(1) **Strict adherence to professional ethics:**

Accountancy, like any other profession, is richly bestowed with good professional ethics, of which strict observance leads to sound practice. In view of this, national accounting bodies should make more serious efforts to ensure their members comply strictly with the code of their professional ethics. This can hardly be over-emphasized.

(2) **Impart moral values in students:**

It has become increasingly necessary that while imparting accounting education, instructors should ensure they in still moral virtues of honesty, integrity and incorruptibility into the fibre of students' character (Sen and Inanga 2007). This is in line with catch them young policy" so that when they grow in the profession, they will not depart from it.

(3) **Introduction of forensic accounting:**
Forensic accounting, otherwise called investigative accounting done by accounting consultants to solve problems, should be introduced in Nigeria. In the USA, to check creative accounting, the practice of forensic accounting is on the increase (Sen and Inanga, 2007). We can also benefit from it.

(4) **Punishment for erring accountants:**
National accounting bodies and government in Nigeria should introduce adequate punishments for accountants that engage in creative accounting. The punishment should be brought to bear on anybody who commits the offence irrespective of the person's position or political affiliation, so as to serve as a deterrent to others.

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