



THE EMERGENCE OF CREATIVE ACCOUNTING IN INSUFFICIENTLY REGULATED BUSINESS SYSTEMS

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Abstract:

Creative Accounting is a concept whose increasing market fluctuations, uncertainties and pressures are coming to the forefront. The aim of this research is to prove that creative accounting, as a practice, most often occurs in those organizations that have not formulated and implemented internal procedures and controls in their organizational system or may not consistently apply them. Furthermore, strengthening corporate culture and constant work on the loyalty and ethical aspects of decision making of employees largely prevents the emergence of creative accounting in that organization. To find the evidence to support our research questions, a survey was conducted in the form of a questionnaire, while respondents were employees from the sectors of Accounting, Finance, Auditing, as well as graduate students in the fields of Accounting, Auditing and Management in major cities in the Republic of Serbia.

Keywords:

creative accounting, financial statement, internal procedures, loyalty.

1. INTRODUCTION

Under the conditions of increasing market uncertainties, which are further intensified by the current pandemic in the world, the challenges for business survival are stronger and more pronounced. Financial indicators are especially sensitive to these circumstances, which are under the scrutiny of both internal and external users. Regulating the business system in the form of financial information flow and allowing a certain degree of responsibility requires a control and risk management system which timely and accurately detects any possible deviation from both legally defined norms and internal procedures, one of the main preconditions for financial statements to realistically reflect the situation.

When the term "Creative Accounting" is mentioned, most people react as if it is something illegal and that is a priori bad. Under the conditions in which business is currently conducted in the Republic of Serbia, which has been in transition for a long time, individuals believe that creative accounting techniques are a powerful weapon in the hands of accountants and people employed in the financial sector, thanks to which they survive in the market and achieve business goals.

Global experiences (Enron, Xerox, Parmalat, WorldCom), on the other hand, have demonstrated to us that the inappropriate use of creative accounting in compiling and presenting financial statements has led to the downfall of the companies themselves. Parmalat as an example of one of the largest financial frauds in Europe from the late 20th and early 21st century, and its equivalent in the US - Enron severely shook confidence in the information presented in the financial statements. All this contributed to the additional destabilization of the capital market, which was already vulnerable during the recession.

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The Sarbanes-Oxley Act (SOX) was passed in 2002 as one way to put an end to the practice of false financial reporting. The intention of the Congress was to restore public confidence in the true and fair view of financial statements in the US. This law prescribes to corporate accountants the following: the high standards that apply to your profession will be strengthened without exception; auditors will be revised; accountants will be held accountable (Hoopwood, et al 2014).

However, despite all the efforts of the government and international financial reporting standards, creative accounting has become an increasingly common practice and it is extremely difficult to establish that fine line between creative accounting and falsifying business changes.

This topic will be discussed using the following pattern: the first part is dedicated to defining the concept of creative accounting, the second part deals with the similarities and differences between creative and conventional accounting, the third part states the shortcomings in the control procedures of a system that lead to the emergence and abuse of creative accounting and the last part analyzes data obtained from respondents through the questionnaire, as well as provide answers to research questions.

2. WHAT IS CREATIVE ACCOUNTING?

Creative Accounting involves the use or misuse of accounting techniques and principles to present financial results that intentionally deviate from fair and true presentation (O'Regan, 2006). The terms "*cosmetic*" accounting, "*tuning*" of profits appears as synonyms (Knežević, et al 2013), as well as "*manipulative*" accounting (Belak, 2011). Creative accounting is the transformation of financial accounting figures from what they actually are to what a preparer desires them to represent by taking advantage of the existing rules and/or ignoring some of all of them (Naser, 1993).

The Anglo-Saxon model of financial reporting (which is also applied in the Republic of Serbia through the usage of International Financial Reporting Standards - IFRS) is characterized by a broad range of reporting methods and compared to the Continental Reporting System has weaker legal regulations. Because of that, the Anglo-Saxon model provides experienced accountants a wide range of creative accounting techniques.

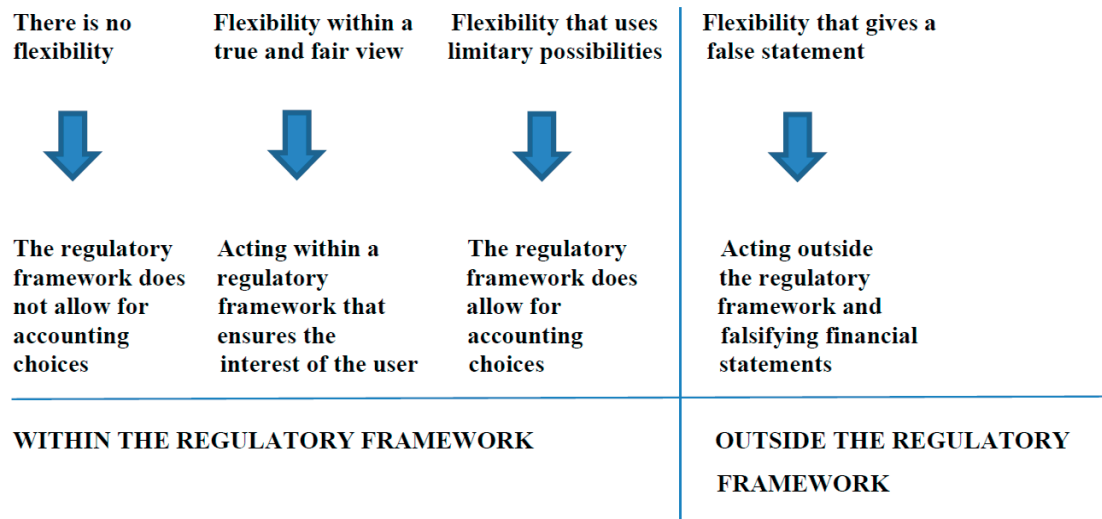
Table 1. Common Labels for the Financial Numbers Game

Aggressive accounting	A forceful and intentional choice and application of accounting principles done in an effort to achieve desired results, typically higher current earnings, whether the practices followed are in accordance with GAAP or not.
Earnings management	The active manipulation of earnings toward a predetermined target, which may be set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earning stream.
Income smoothing	A form of earnings management designed to remove peaks and valleys from a normal earnings series, including steps to reduce and "store" profits during good years for use during slower years.
Fraudulent financial reporting	Intentional misstatements or omissions of amounts disclosures in financial statements, done to deceive financial statement users, that are determined to be fraudulent by an administrative, civil, or criminal proceeding.
Creative accounting practices	Any and all steps used to play the financial numbers game, including aggressive choice and application of accounting principles, fraudulent financial reporting and any steps taken toward earnings management or income smoothing.

Source: Mulford, C.W., Comiskey, E.E., (2002), The Financial Number Game (Detecting Creative Accounting Practices), John Willey & Sons, Inc.

Observing the above-mentioned definitions and interpretations of creative accounting, one can get the impression that its application always leads to the occurrence of criminal acts, but this is not always the case. Considering that the IFRS accounting standards of financial reporting, which are in use in the Republic of Serbia, allow a certain amount of flexibility in valuing balance sheet items at fair value, organisation has the possibility of applying a different valuation method.

Selecting the appropriate method greatly affects the recognition and valuation of assets, as well as the result of operations and financial position of a business system. The creativity and objectivity of accounting is based on the level of rationality and objectivity of persons who interpret rules (Gerboth, 1987).

**Picture 1.** Defining the scope of creative accounting according to the flexibility of the financial reporting framework

Source: Belak, V., (2011), Poslovna forenzika i forenzičko računovodstvo, Belak Excellens..

3. CONVENTIONAL VS CREATIVE ACCOUNTING

The main goal of financial reporting, and thus accounting, *which as a final result of its work compiles and presents financial statements*, is to make transparent all transactions arising in the business of the company and to clearly state their consequences for property, financial and yield position of the company in the financial statements (Škarić-Jovanović, 2006).

Conventional Accounting is based on IFRS standards. In the Republic of Serbia, according to the current Accounting Act, depending on the size of the business entity, a set of financial forms may contain - a *Balance Sheet, Income Statement, Cash Flow Statement, Statement of Changes in Equity, the Report on the Other Result* as well as the *Notes to the Financial Statement*. One of the main functions of financial statements is to create a business decision based on the data presented in them. The information used from the financial statements depends on the nature of the business decision that is made - investment, credit, tax, and, ultimately, the public, which is very interested in future trends, and perhaps some local companies as well.

All measures and actions that are adopted and implemented with the aim of compiling financial statements that do not show the results of operations and the financial position of the business entity itself are classified as *Creative Accounting*. As a result, legal and regulatory rules may or may not be violated. If, however, there is a violation of legal and professional regulations, then we can say that creative accounting grows into false financial reporting (Kaparavlović, 2011). Whether it is creative accounting that violates or does not violate legal and professional regulations - creative financial reporting seriously derogates from the use value of financial statements, either

in terms of direct use of information contained in them, or as an information basis for a serious analysis of company performance (Malinić, 2009).

4. LACK OF CONTROL PROCEDURES

In the absence of clear and precise internal procedures and controls in a business system, there is an abuse of authority by individual employees, as well as abuse of information available to them. The deficiencies in control procedures that mostly lead to fraud in a business system include: an inaccurately defined accountability policy for each level of management, the non-existence or poorly defined accounting policies, an inadequate system of punishing and rewarding employees, the unregulated flow of documentation starting from the entry of documentation into the organization until it is registered and postponed, the impossibility of measuring the performance of each employee, the absence of the internal control sector, the compliance sector, and the absence of an external auditor. The list is certainly even longer depending on the nature of each business system.

Because of all these shortcomings, there is disloyalty among employees and a feeling of their absence of belonging to the organization which employs them. Under these circumstances, the reactions of employees are quite unpredictable. Reactions can range from complete disinterest to immeasurable greed, as they are aware that the business system in which they are employed will find it difficult to recognize irregularity in the absence of control procedures or ultimately will not recognize it at all.

The current situation in the Republic of Serbia is such that most micro, small and even medium-sized companies rarely have clearly defined control rules and procedures.



For the most part, large business systems that are under the influence of foreign investors, such as banks, insurance companies, various investment funds, representative offices of foreign companies in the Republic of Serbia are aware of the transparency that must exist in their operations. As one of the main preconditions for this transparency are clearly defined rules within organizations. Special attention is paid to the sector of internal audit, compliance, as well as continuous trainings of all employees in accordance with their job description. Seminars and trainings exist on the topic of code of ethics and building a corporate culture, specifically in the accounting sector, so that employees know how to behave in specific situations, which can be even risky, if ignorance of the code of ethics and sanctions within the business system is present among employees.

The analysis of the collected data will be presented through the answers to two research questions – *Research Question No. 1: Only consistent application of both legislation and internal procedures in the business system can lay the foundation for realistic reporting;* and *Research Question No. 2: Strong corporate culture in an organization and constant work on mutual trust between employees and between managers and employees are a very important factor in preventing the onset of creative accounting in a business system.*

5. RESEARCH METHODOLOGY AND RESULTS

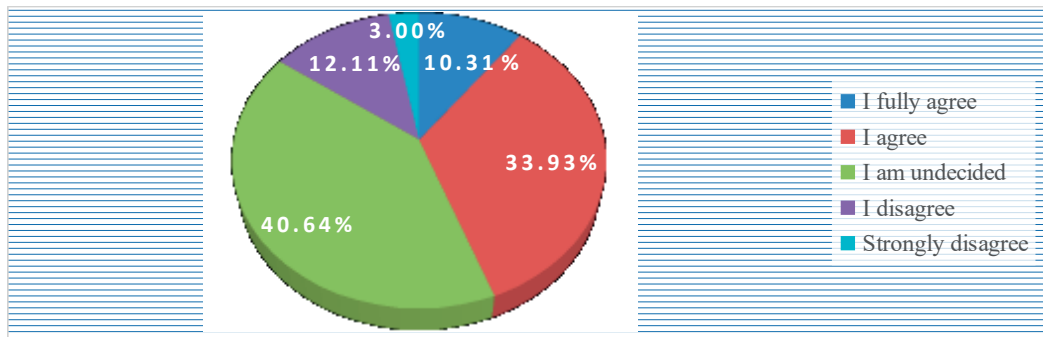
An anonymous questionnaire was chosen as the basis method of data collection. All data were collected in April 2021. The focus of the research is on employees in the sector of Accounting, Finance, Auditing, as well as graduate students in the fields of Accounting, Auditing and Management. Questionnaires from the above areas were sent to employees at different levels of management in order to get a more realistic picture of the current situation in the Republic of Serbia. Special attention was also paid to the opinion of graduate students, because they are expected to be creators and participants in the complex business processes in the future. Respondents were asked to provide honest answers to the questions asked. A total of 198 questionnaires were sent, of which 169 completed questionnaires were received. Of the number of questionnaires received, 32 questionnaires were not included in the analysis, because the respondents did not give complete answers to the questions, hence their answers were not deemed relevant to the survey, meaning that the subject of the survey included 137 complete questionnaires, which makes the answer rate 69.2 % of the total sample. We consider this rate to be relevant for drawing specific conclusions; however, the size of the sample certainly does not allow us to take a stand in the form of rules, but rather

provide guidelines for which direction we should pay additional attention. It is encouraging that a large number of respondents wanted to answer the questions asked. Some even gave comments in the form of suggestions and their personal views, which certainly contributes to the relevance of the research. The respondents are mostly from larger cities in the Republic of Serbia - Belgrade, Novi Sad, Subotica, Kragujevac, and Zrenjanin, where economic flows are dynamic and which face almost daily dilemmas that this research seeks to cover. Some of them are also owners of the companies in which they work.

At the beginning, we were interested in the extent to which the respondents were familiar with the term *Creative Accounting*, as well as the way in which they would define it. Opinions are divided in the sense that 51.8% of the respondents answered that they were familiar with the term *Creative Accounting*, while 48.2% said that they were not familiar with the term, and that they have not encountered it in everyday life. When asked to define the concept of creative accounting, as many as 64.8% agreed that it is *an accounting practice that deviates from the prescribed standards*. We were also interested in how respondents would classify engaging in creative accounting - almost half, 43.7% of them did not want to declare themselves, 31.1% believe that this should not be a practice, while 25.1%, a quarter of the total respondents, believe that creative accounting is a necessity. There is always a dilemma, which side would be taken by the respondents who did not want to declare themselves, but that certainly speaks in favor of the fact that creative accounting is a delicate matter, and for many of them this is still something they do not want to declare publicly. The intention was to find out for what purpose the respondents most often *use financial statements*, as well as what they think *potential "targets"* of creative accounting are - as many as 41.9% of respondents answered that they most often use financial statements to make *management decisions*. The most common *"targets"* are *taxes, supplies, revenues and net cash flow*. These two questions and the answers to them show us how important it is for the financial statements to present the situation in the business system in a credible and realistic way, because the financial data from them are used for making extremely important business decisions. The answers to the question regarding the currently valid legal regulations in the Republic of Serbia can be seen in *Figure 1*:



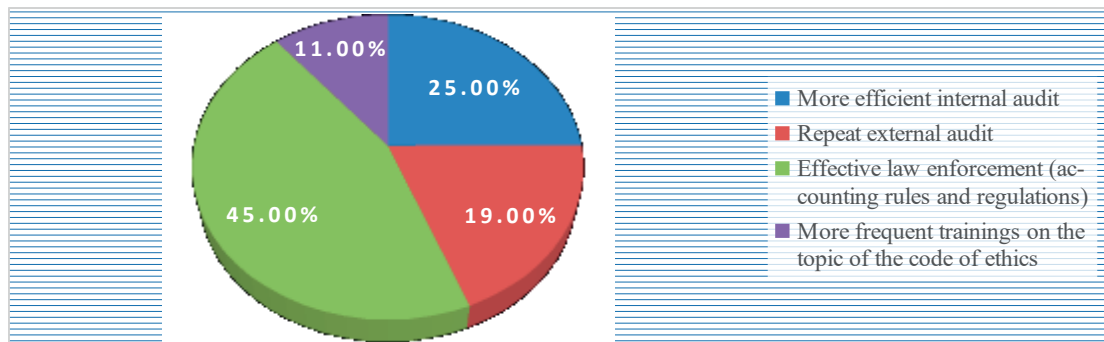
Figure 1. Legal regulations in the Republic of Serbia are those whose interpretation provides the possibility for the application of creative accounting (value adjustment of trade receivables, the method of valuation and depreciation of fixed assets, recognition of revenues and costs, etc.)



The figure shows that if we collect respondents who fully agree and who agree with the above question, we come to the conclusion that as many as 44% of respondents believe that the emergence of creative accounting is not only caused by insufficiently regulated business system, but even more insufficiently precise and consistent applicable legislation, specifically in the territory of the Republic of Serbia.

In accordance with the *Research Question No. 1 - that insufficiently regulated business systems lead to the emergence of creative accounting*, Figure 2 shows the opinions of respondents on this topic:

Figure 2. What is in your opinion the best way to detect and suppress creative accounting?



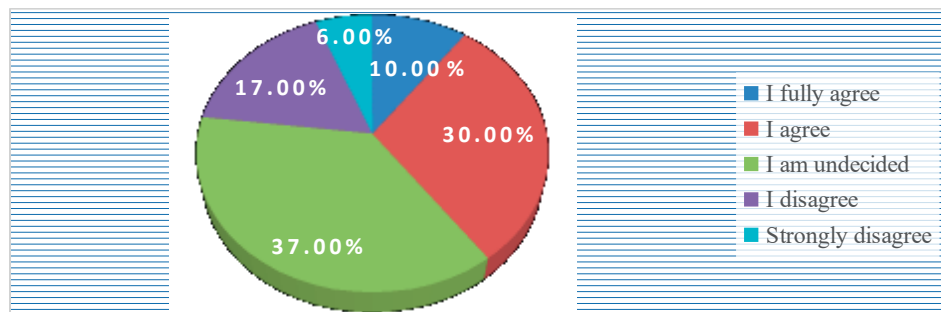
It is interesting to note that as many as one half of the respondents believe that the consistent application of legal regulations in the business system is the best way to recognize and suppress creative accounting. One quarter of respondents believe that conducting an effective internal audit is the best way to detect any indications of creative accounting, *which gives us the answer to First Research Question and confirm it - that only consistent application*

of both legislation and internal procedures in the business system can lay the foundation for realistic reporting.

In Figure 3, we can see that as many as one third of the respondents believe that accounting policies, internal control systems and procedures in their organizations are designed so that there is no way for the emergence of creative accounting:



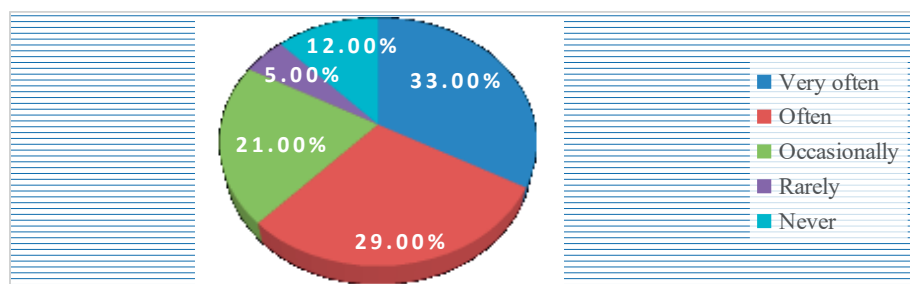
Figure 3. In an organization where you are employed, accounting system (internal control system) is so organized that there is no way to manipulate the financial statements or on some of the balance sheet items



To get an answer on *Research Question No. 2 - a strong corporate culture in an organization and constant work on mutual trust between employees and between managers and employees are a very important factor in preventing the*

onset of creative accounting in a business system, respondents were asked the question in which way they solve the observed irregularities in the work itself:

Figure 4. You are doing your job and you notice that certain financial items in gross balance are illogical, you contact your superior and present him the observed irregularity



More than half of respondents agree that they would almost always notify their supervisor when they would notice certain irregularities in their work, which is encouraging, and *we can conclude that the answers of the respondents to a greater extent confirmed our Second Research Question in the survey.*

6. CONCLUSION

True and reliable financial reporting is essential for any organization that desires to operate for many years and enjoy public confidence. Creative accounting as an instrument for "correcting" certain data in financial statements often casts a shadow on the reputation of the organization that implements it, as well as on the individual employee who is the direct implementer. The topic is complex and delicate precisely because many different factors are involved in implementing a practice of creative accounting. Because of this complexity, it is a real challenge to take adequate control procedures to prevent such practices. The results of the survey set by *Research Question No. 1* proved to us that when internal controls are in an organizational

system, with constant monitoring of the implementation of legal and accounting standards, the emergence of creative accounting is significantly reduced.

Corporate culture as something that organizations build over the years and which largely depends on the rules of conduct and the profile of their employees, also affects the emergence of creative accounting. Healthy and collegial relationships between employees, as well as between employees and their superiors, contribute to loyalty to the organization in which they work. Loyalty to the organization, combined with a properly and fairly established system of reward and punishment, is certainly something that prevents the emergence of creative accounting in the organization. This is to a greater extent proven by the survey in *Research Question No. 2*. because loyalty is something that cannot be accurately measured and which certainly interferes with the morality and code of ethics of each employee. This will certainly be given more attention in future research.



7. LITERATURE

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