



Avoiding creative accounting: corporate governance and leadership skills

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Abstract

The subject of the research is the growing criticism of the phenomenon of creative accounting in modern economic systems. The main purpose of the article is to study the issues related to creative accounting and find out whether it is possible, through organizational culture and corporate governance principles, to influence accountants' decisions regarding the use of creative accounting. The research methodology is based on theoretical and empirical research. The authors have tried to explain the phenomena of creative accounting and distinguish creative accounting from the anomalies of accounting fraud. The main result of the research is proof that it is possible and necessary to apply the leadership concept to reduce the negative consequences of creative accounting. The abuse of creative accounting methods should be eliminated by improving ethical norms. In turn, improving ethical standards is impossible without developing leadership skills among people who are professionally engaged in accounting.

Keywords: creative accounting, leadership skills, corporate governance, Sarbanes–Oxley (SOX) Act, manipulations with information.

Streszczenie

Unikanie kreatywnej księgowości: ład korporacyjny i umiejętności przywódcze

Przedmiotem badań jest rosnąca krytyka zjawiska kreatywnej księgowości we współczesnych systemach gospodarczych. Głównym celem artykułu jest zbadanie zagadnień związanych z kreatywną rachunkowością i ustalenie, czy przez kulturę organizacyjną i zasady ładu korporacyjnego możliwe jest wpłynięcie na decyzje księgowych w sprawie stosowania kreatywnej rachunkowości. Autorzy starali się wyjaśnić zjawiska kreatywnej księgowości, wyznaczyć granice jej pozytywnego wykorzystania oraz oddzielić kreatywną księgowość od anomalii oszustw księgowych. Głównym rezultatem badań jest wykazanie, że możliwe i konieczne jest zastosowanie koncepcji przywództwa w celu zmniejszenia negatywnych konsekwencji kreatywnej rachunkowości. Nadużywanie metod kreatywnej rachunkowości powinno być wyeliminowane przez doskonalenie norm etycznych. Z kolei poprawa standardów etycznych nie jest możliwa bez rozwoju umiejętności przywódczych wśród osób zawodowo zajmujących się rachunkowością.

Słowa kluczowe: kreatywna rachunkowość, umiejętności przywódcze, ład korporacyjny, ustawa Sarbanes-Oxley (SOX), manipulacje informacjami.

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Introduction

The distinctive trend of modern accounting's development is the growth of its creativity, which is manifested in the fact that specialists can use accounting methods that do not correspond to generally accepted practice, standards and principles. The subject of the research is the growing criticism of the phenomenon of creative accounting in modern economic systems. The main objective of the study is to demonstrate the importance of using the leadership concept to reduce creative accounting and thus overall company risk. Within the framework of the phenomenon of creative accounting, the authors have tried to explain the phenomena of creative accounting and distinguish creative accounting from the anomalies of accounting fraud.

Within the research, the methodology of exploratory and conclusive research designs was used. After secondary research, we conducted primary qualitative and quantitative studies. Seven respondents – accountants of Kazakhstani companies with more than three years' experience in accounting – were interviewed. Then, based on qualitative research data using convenience sampling, a cross-sectional online survey was conducted. The target audience was accountants and employees of Kazakhstani companies of the city of Almaty. The number of people in the sample was $n = 68$.

The results of the study showed that the introduction of corporate governance principles, and the development of a culture of leadership in the company, have an impact on the performance of personnel, which can also manifest itself in their refusal to provide false reporting and their rejection of creative accounting.

The practical recommendation of the research is the necessity to improve the code of ethics for Professional Accountants focusing on the aspects of soft skills. A critical assessment of new phenomena in accounting practice is impossible without engaging the methodology of social sciences.

In 1986, the British journalist and economic observer Ian Griffith coined the term "creative accounting," stating the problem of creative accounting as follows: "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... In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting" (Griffith, 1986).

In the Republic of Kazakhstan, as in many other developing countries, methods of creative accounting are not sufficiently developed and are limited mainly to the use of legal ways to reduce taxes. The accountant's creativity is limited to choosing the most convenient provisions for accounting and consolidating the chosen strategy in the accounting policy of the company. As markets develop, there will be an increase in the number of companies applying creative accounting.

The reasons for the introduction of creative accounting in Kazakh organizations are that accounting and reporting are controlled by the administration of the company. At the same time, managers, reporting on the results of their work to the owners, seek to

show the positive aspects of the property and its financial situation. It is generally agreed that the purpose of creative accounting is to improve financial reporting in order to attract investors and creditors. This purpose is realized by the artificial exaggeration of losses of the current year, so that the growth of profits (losses) in the following years, when they plan to attract investors, would seem especially impressive.

1. Materials and methods

The first phase of the study included secondary research of the problem. We studied published materials, sites on the research topic, practice of creative accounting. After conducting the secondary study, we proceeded to the next phase, namely, collecting primary qualitative information. The research must be perceived as exploratory one. Seven interviews were conducted among employees of Kazakhstani companies who worked in accounting departments. As a result, based on the data obtained from the interviews, a questionnaire was developed using structured questions for a quantitative study that would be carried out using an online survey. The questionnaire was designed with the target respondents in mind, taking into account their educational level and experience in accounting. The types of questions used in the questionnaire were closed-ended ones, such as dichotomous questions, multiple-choice, a Likert scale, an importance scale, and a Semantic Differential Scale. The preliminary testing was conducted among undergraduate and postgraduate students majoring in accounting at the University of International Business (UIB), Almaty Kazakhstan. The preliminary testing and online survey were based on convenience and nonprobability sampling. Despite its quickness, convenience sampling has serious limitations, such as selection bias and the difficulty of generalizing the results of the research to the population. To overcome this problem, descriptive or causal research is needed for further investigation. The Russian and Kazakh languages were used. A cross-sectional survey was conducted with $n=68$ employees working in private companies and organizations.

We wanted to find out whether accountants consider acquiring leadership skills (soft skills) to be important for them. As a result, along with other external factors, a developed leadership culture could help to avoid creative accounting in many cases. Our prediction is based on the statement that low awareness of leadership skills leads to the poor performance of any activity where people interact (Zakirova, Soloaga, 2018). The findings taken from the survey showed that the majority of respondents (64.5%) agree that an accountant must possess leadership skills, 7% strongly agree, 22.6% did not agree, 3.9% strongly disagree, and 2% did not know. To the question, "Are leadership qualities important for accountants?" 54.8% of respondents answered "yes." Such results for this answer were surprising, because testing showed only 26% positive responses. The question "What qualities are most important for an accountant?" showed that 90.3% of respondents value professional skills, and 58.1% of them – diligence. Leadership and communication skills are important only for 16.1% of the respondents.

The question on the semantic differential revealed 45.2% of respondents consider that a good accountant influences the company's decisions and the same number of respondents think that accountants possess expert authority. 9.7% of respondents think that a good accountant must be a real leader. 22.6%, 12.9%, and 45.2% of respondents said that it is extremely important, very important, and highly important, respectively, to pay much attention to management in educational programs; at the same time, 19.4% answered that it is not so important.

Summing up the empirical research, we believe that there is a change in the minds of Kazakhstani accountants and employees. The majority of the respondents are aware of the importance of management for professional accounting activities.

2. Literature review

Creative accounting, as a new modification of the processing of economic information, offers a creative approach to forming and developing the accounting policies of an organization. Creative accounting arises from the relationship between the professional judgment of an individual accountant and the consequences of making management decisions based on a “creative” approach.

Some authors believe that the options based on freedom of choice and evaluation allow companies’ management to “translate legal, economic and financial innovations for problems that cannot yet be solved”, which leads to creative accounting, and thus “the shaping of results and financial statement contents” (Marilena, Corina, 2012, p. 351). For them, creative accounting is just “the shaping of results.”

They explain this phenomenon by the existence of various economic and accounting uncertainties in the external environment that results in the financial statements not being properly assessed. As a result, the management option for one of these processing and accounting policies creates the opportunity to choose a decision that is in the best interests of the company. However, this decision may not always lead to a true image; rather it puts the image of the company in a better light. Thus, a misrepresentation in financial information takes place, creating ambiguity regarding the logic and comparability of information designed for stakeholders, “in which case we are dealing with intentional accounting, in other words, we are entering the sphere of creative accounting” (Marilena, Corina, 2012).

Recently, there has been growing criticism of the phenomenon of creative accounting (Brauweiler, 2017). In another paper, Brauweiler (2018) found a correlation between leadership culture and avoiding the practice of creative accounting, which leads to a reduction in risk for the company.

Popa (2012, p. 1272) states that “creative accounting is one of the manipulative practices that has been strongly enhanced in the financial field as time has passed.” Although this practice is subject to the law, it intentionally misleads users of financial information, thereby creating a false perception of the company. At present, creative accounting has become a complex phenomenon, the consequences of which are of concern to in-field specialists.

Bala (2013, p. 63) supposes that the development of corporate governance and its use “in raising the efficiency of companies’ performance” will lead to “reducing the practice of Creative Accounting because Corporate Governance has an effective role in determining the Quality of Accounting Information”. We think adherence to the principles of corporate governance can undoubtedly solve the problem of the widespread use of creative accounting. Other authors have other ways to solve this problem. For example, the probability of detecting creative accounting depends on its size and the transparency of the budget (Milesi-Ferretti, 2004).

Creative accounting, as well as various schemes of window dressing and off-balance sheet financing, are much discussed. Yet, Naser and Pendlebury (1992) went further. They revealed the extent to which such schemes are used in reality. In their research, the results of a survey of senior auditors concerning their experience of creative accounting are reported, with the auditors being asked to point out how frequently they had faced the problem. They also studied the auditors’ perceptions concerning: “the motives companies might have for using creative accounting; the consequences of the continued use of creative accounting; and the steps that need to be taken to eliminate the use of creative accounting are also analyzed” (Naser, Pendlebury, 1992, p. 111).

3. Results and discussion

The objectives of creative accounting vary in countries with different levels of economic development and different accounting systems. In Kazakhstan, like many other countries of peripheral capitalism, creative accounting is poorly developed and is limited mainly to the use of “white” tax schemes, i.e., legal ways to reduce the tax burden.

Developed market countries that have the most favorable investment climate are distinguished by their creative consideration of a different goal, which is improving financial reporting indicators in order to attract investors and creditors (Zirkler et al., 2018). Countries with an Anglo-Saxon accounting model, which is distinguished by the breadth of acceptable reporting methods and relatively weak (compared to the continental model) legislative regulations, provide the greatest number of opportunities for bookkeepers to apply creative technologies.

The purpose of creative accounting is achieved in a developed market economy in the course of carrying out the following tasks:

- The smoothing of income, i.e., presenting real growth in profits but making it seem this growth occurs without sporadic fluctuations, including short-term falls in the level of income, which might alert the investor. Opponents of creative accounting point out that smoothing unprofitable revenues disguises long-term trends in changes in profits. A variation of income smoothing is the “big bath accounting” method: an artificial exaggeration of the losses of the current year so that the growth in profits in subsequent years – when they plan to attract investors – would seem particularly impressive.

- The predictability of profitability, i.e., presenting income in which it is not only smoothed out but it is also as close as possible to that predicted by in-house and external experts. The alleged predictability of profitability creates the effect that the company fully meets expectations and has never deceived investors.
- Masking financial difficulties, i.e., a one-time imaginary increase in revenues during a period of temporary difficulties, in order to hide behind a “smokescreen” any problems that have arisen, thereby supporting the company's reputation and popularity.
- Masking the volume of borrowed funds, i.e., a temporary artificial decrease in the reporting of the share of borrowed funds in the company's capital to better regulate the stock price.
- Masking insider trading, i.e., the temporary concealment of information about certain contracts and their financial consequences in order to achieve the maximum effect from the announcement of this information when selling shares.

Creative accounting methods are divided into four categories. The first category represents the choice of different accounting technologies from among those stipulated by accounting standards, e.g., the choice of the depreciation method of fixed assets, the method of taking into account the purchased values (FIFO and LIFO), the method of calculating expenses, etc. The full set of accounting technologies selected by a company is approved by the accounting policy and is not subject to change during a certain period (at least one tax period), which is dictated by the accounting principle of consistency.

The second category represents the variability of the valuation of assets and liabilities. Certain accounting records inevitably assume the variability of valuation and, in particular, the prediction of subsequent fluctuations in the value of the accounting object. This is clearly seen in the example of the revaluation of financial instruments and securities. Another case is barter transactions using transfer prices when the parties to the transaction use the maximum possible market price for the goods exchanged in the documentation. This makes it possible to optimize the value-added tax and inflate costs that reduce taxable income while maintaining the same solvency.

The third category is artificial (deliberate) transactions, in which a third party is most often presented as an intermediary – usually a bank to which the obligations of one of the parties are transferred. Artificial transactions are designed to change the structure of the balance and move the amount of profit between different tax periods.

The fourth category includes real transactions: they are negotiated at such a moment and with such a calculation that eventually they result in an improvement in financial reporting. As a result, it makes it possible to create a favorable impression on investors.

Over the past two decades, serious accounting scandals have occurred in large companies, such as WorldCom and Enron, and in the banking sector with BCCI, Barings, Allied Irish Bank, and Bankinter. The problem of creative accounting, with its legal and illegal aspects, entered the agenda of commercial firms and governments. Omurgonulsen and Omurgonulsen (2009) found important reasons for creative accounting practices, such as:

- weaknesses of the legal frameworks of banking and accounting,
- inadequacies in the autonomy of state regulatory and supervisory authorities,
- practical difficulties in enforcing legal and ethical standards due to the slow functioning of the judicial system,
- the personal greed of owners and top managers.

Their research proved that “the intention and capability of political power in combating such kind of corruption are... crucial” (Omurgonulsen, Omurgonulsen, 2009, p. 651).

In general, the attitude of most major researchers to the problem of creative accounting is somewhat negative. Michael Jameson (1988) stated that accounting implies the need to deal with various judgments and resolve contradictions between the presentation of the results of a financial event and the essence of transactions. He argued that this flexibility opens up possibilities for manipulation, deception, and distortions. Such violations were practiced by the least scrupulous members of the accounting profession and have now become known as “creative accounting”.

Carrying out such actions, the preparers of financial statements are obliged to consider that if the profit figures have been reduced, then, if necessary, the publication of real statements will entail various negative consequences.

The intensification of work to create a code of accounting ethics, primarily in the United States, marks an attempt to eradicate such abuses by the forces of the accounting community itself. The modern mainstream of business ethics is opposite to the “selective financial misrepresentation hypothesis”, formulated in 1991 by Revsine and justifying embellishment of the balance for the reason that managers are hired for adventures, which is why they have to work out their money by undertaking accounting adventures within the law.

In this regard, New Zealand’s experience is a source of great optimism for accounting associations. Their system of accounting standards and the legislative regulation of accounting, in combination with the activities of self-regulating accountants organizations, have greatly reduced the possibilities of using creative accounting technologies.

Some researchers of the accounting system note the duality of the nature of creative accounting, emphasizing that income smoothing disguises long-term trends in profit margins. It is worth noting that creative accounting is the subject of numerous discussions in professional circles.

The provisions of IFRS that give management the right to use professional judgment in some cases are often criticized (Wagner, Brauweiler, 2011). The Sarbanes-Oxley (SOX) Act of 2002 is a United States federal law that set requirements for all U.S. public company boards, management, and public accounting firms.

Zhang et al. (2018) studied the effect of SOX on corporate innovation. According to their findings, SOX dramatically changed corporate governance landscape of public firms in the U.S. They found that SOX increases corporate innovation, as measured by the number of patents and the number of citations per patent. The effects are stronger for firms facing more serious agency problems, i.e., firms with more entrenched CEOs

and firms with low institutional ownership. The effect is also found to be stronger for firms operating in innovative industries (Zhang et al., 2018).

A recent survey by Chu and Hsu (2018) proved that there are positive effects of the regulations of SOX in governing the independence of auditors.

The study by Graham and Moore (2018) examined the effect of the SOX on accounting distortions in the context of the earnings quality of high-growth firms relative to lower-growth firms. The results of the study “suggest greater reductions in accounting distortions and related improvements in reporting quality for high-growth firms relative to other firms coinciding with the post-SOX period” (Graham, Moore, 2018, p. 82).

Moreover, C. Richard Baker claims that “credible financial reporting and the independence of auditors helps to provide greater societal control over corporations.” He goes on to say: “In the absence of explicit multinational structures to reign in corporate power,” except for effective systems of financial reporting and corporate governance, “it is difficult to conceive of any other potential control mechanisms” (Baker, 2008, p. 114).

Corporate governance mechanisms are designed to ensure that the board of directors is accountable to shareholders, management – to the board of directors, large shareholding owners – to minority shareholders, and corporations – to employees, customers, and society as a whole. Corporate governance focuses on ensuring that all these groups and institutions perform their functions in the best possible way while maintaining a balance of interests between them.

Thus, the corporate governance system creates a favorable environment for avoiding excessive creative accounting. In turn, the personal and social responsibility of accountants, strengthened through the development of leadership qualities, is able to resist fraud and the manipulation of information. Of course, we should all remember the accountants of American corporations who openly declared fraud in their companies.

Leadership and power through soft skills are able to deal with new challenges. In addition, most authors note that two factors can make it possible to face changes effectively. The first is fundamental systems; that is, an organization must prepare the ground for all the processes that will take place in the organization, for example, applying corporate governance principles. The second is the level of comprehensive skills of the organization’s leaders. In an ever-changing world, the development and cultivation of the company employees’ leadership skills is an integral part of the organization’s strategy. The practical consequence of the research paper lies in the possibilities to increase accountants’ responsibility by mastering leadership skills to avoid manipulations of accounting information. It is probably true to say that there is low awareness concerning leadership skills among Kazakhstani accountants. This leads to a decrease in their overall performance; thus, they avoid responsibility and, as a result, there is a potential loss of opportunities.

Creative accounting consists of accounting practices that follow the required laws and regulations, but that deviate from what those standards intend to accomplish. Creative accounting capitalizes on loopholes in accounting standards to falsely portray a better image of the company. Although creative accounting practices are legal, the

loopholes they exploit are often reformed to prevent such behaviors. For example, creative accounting can be used to manage earnings or to keep debt off the balance sheet. Creative accounting, which was designed to play around with the numbers, and thus enrich some individuals at the company, turned into the outright illegal handling of the books and reporting to the public.

Emerging abuse based on creative accounting practices can be eradicated by improving ethical and accounting practices. To this end, one should note the achievements of the United States which are aimed at intensifying the work on the further development of the code of accounting ethics.

Conclusions

The objective of the research was to prove that accountants' responsibility could be improved via developing a culture of leadership in a company. Moreover, along with other external factors, the developed leadership culture could help to avoid creative accounting in many cases. The prediction was based on the statement that low awareness of leadership skills leads to the poor performance of any activity where people interact. The findings taken from the survey showed that nearly half of respondents (54.8%) agree that an accountant must possess leadership skills.

There can be no doubt that there are ethical implications of making management decisions based on creative accounting, and it leads to a distortion of financial information, and it creates an ambiguity regarding the logic and comparability of information intended for stakeholders. Creative accounting is one of the manipulative practices which has recently greatly increased in the financial sphere. The practice is subject to the law; however, it intentionally misleads users of financial information, thereby creating a false perception of the company. The development of corporate governance leads to a reduction in the practice of creative accounting since corporate governance plays an effective role in determining the quality of accounting information. Principles of corporate governance, of course, can solve the problem of the widespread use of creative accounting.

Creative accounting is developing in Kazakhstan. Countries with an Anglo-Saxon accounting model, which is distinguished by the breadth of acceptable reporting methods and relatively weak (compared to the continental model) legislative regulations, provide the greatest number of opportunities for bookkeepers to apply creative technologies.

In general, the attitude of most major researchers to the problem of creative accounting is somewhat negative and is the subject of numerous discussions in professional circles. The provisions of IFRS that give management the right to use professional judgment in some cases are often criticized.

The Sarbanes-Oxley (SOX) Act of 2002 has positive effects in governing the independence of auditors and suggests greater reductions in accounting distortions. In the

absence of explicit multinational structures to reign in corporate power, it is difficult to conceive of any other potential control mechanisms apart from effective systems of financial reporting and corporate governance. The corporate governance system creates a favorable environment for avoiding excessive creative accounting. In turn, the personal and social responsibility of accountants, which are strengthened through the development of leadership qualities, are able to resist fraud and the manipulation of information.

Leadership and power through soft skills are able to deal with new challenges. In addition, most authors note two factors that can make possible to face changes effectively. The first is fundamental systems, i.e., the organization must prepare the ground for all processes that will take place in the organization, e.g., applying corporate governance principles. The second is the level of comprehensive skills of the organization's leaders. In an ever-changing world, the development and cultivation of the company employees' leadership skills is an integral part of the organization's strategy. The practical consequence of the research paper lies in the possibilities to increase accountants' responsibility by mastering leadership skills to avoid manipulations of accounting information. It is probably true to say that there is low awareness concerning leadership skills among Kazakhstani accountants. This leads to a decrease in their overall performance; thus, they avoid responsibility and, as a result, there is a potential loss of opportunities.

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