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The Impact of Creative Accounting and Auditing on Business Administration and Maximizing the Value of Business

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Introduction

According to the extreme significance of accounting information, the increasing number of users and its significant role in decision making, this study aims to highlight the seriousness of creative accounting and its impact on decision making which affects the profits and thus to maximize the value of business as using accounting can uncover fraud and manipulation of financial statements, resulting the lack of credibility and fairness of published financial statements, from a creative accounting perspective.

The creative accounting in considered a contrary to the ethics and behavior of profession as well as a way of manipulation and embezzlement. Thus, the researcher aimed to introduce its methods and ways and its impact on business profits to enable the reader to recognize it very well.

As for the contemporary conditions in business world in beautifying some financial information for the sake of improving the financial state in the view of investors in terms of profitability and financial position for the purpose of achieving personal targets, those administrations tend to employ creative accounting exploiting the diversity of accounting alternatives that can be counted upon in financial statements preparation; obviously, this will negatively affect the credibility of these statements and misdirect users.

The role of auditor comes in detecting manipulation, preventing it, and reducing its effects due to the importance of auditing in detecting such manipulation in statements and financial reports.

The problem of the study:

Due to the importance of accounting information, the ever-growing number of users, its significant role in decision-making process and attracting investment, the creative accounting emerged (cheating and fraudulence). Thus, the level of doubts about the credibility and fairness of financial statements increased which negatively affect the process of decision – making and investment attraction. Hence, because creative accounting is contrary to ethics and conduct of the profession, the researchers finds it is very important to unveil its methods and impacts on profits and business management as well as decision-making process, he also shows the way it can be detected and averted, and how can the auditor reveal all kinds of manipulation and cheating to avoid the risk of creative accounting.

Questions of the Study:

1) What is the meaning of creative accounting?
2) What is the impact of creative accounting on profits?
3) What are the procedures that can be used by users and auditors to lessen the effects of using creative accounting on the preparation of financial statement?
4) How can the methods and procedures of creative accounting influence the credibility of financial statements lists of companies?
5) What is auditing and what is the role of the auditor in reducing the effects of creative accounting?

Hypotheses of Study:

1) Using creative accounting doesn’t affect the credibility of financial statements of the company.
2) There are no procedures that enable users of financial statements to make sure that the creative accounting is not used in such lists.
3) There is no significant effect of using creative accounting on profits.

4) There are no future effects on the company using creative accounting.
5) There is no relationship between the auditor and revealing creative accounting.

Importance of the study:

The importance of the study emerges from using the creative accounting by one company or more, they use deceitful methods to present their business results and financial status in a fake way in order to achieve certain goals and aims which leads to financial crises accordingly, the evidence on that there is a large group of international companies went into bankruptcy.

The Objectives of the Study:

1) Identifying the concept and the emergence of creative accounting and what creative accounting means.
2) Identifying the methods of creative accounting and its impact on profits paying much attention to procedures used by auditors to prevent creative accounting.
3) Paying attention to future consequential effects of using creative accounting and how can methods and procedures of creative accounting affect the credibility of financial statements mentioned in companies' financial lists.
4) Paying attention to the role of auditor in detecting all kinds of manipulation to be avoided.

Previous Studies:

First: Arabic Studies:

1. Rasha Hamada (2010), the role of audit committees in the reduction of creative accounting practices. (A field study):

- Identifying activities that audit committees practice to reduce creative accounting practices.
- Identifying any basic differences between the opinions of accounts auditor and audit committee members about the role of audit committee in the reduction of creative accounting.

The study concluded the following:

- Members of the study sample unanimously concluded that activities carried out by audit committees, conducive to the task of supervision, controlling over financial reports, and studying the internal control system and evaluation, have a significant effect on the reduction of creative accounting practices in companies.
- Members of the study sample concluded that the activities carried out by audit committees related to the task of supporting the internal and external audit function, and governance mechanisms have a medium significant effect on the reduction of creative accounting practices in companies
- Members of the study sample unanimously concluded that activities carried out by audit committees, related to the task of risk management, have a low significant effect on the reduction of creative accounting practices in companies.

2. Dahmish and Abu Zir: "*Ethics of Creative Accounting Display and Analysis*" (2005)

The study aims to:

This study aims at unveiling the role of accounting in providing all parties of business with financial statements which help them make rational economic decision through defying all sorts of manipulation and deception.

- Identifying the opinions of some professional bodies in an attempt to determine the standard of fraud and mistakes in financial reports resulted through practicing creative accounting.

The study comes up with a group of findings which are:

Users of creative accounting, in most cases, are very intellectual so that they can manipulate numbers, in the financial statements, and transfer them in a way they intend. However, this manipulation can cheat some people not all of them overtime. The only solution is that accountants, managers, auditors, employees, administrators and all others have to show some integrity and morals in every single day of work.

3. **Muhsin Babqi: "*The Role of Auditor in Facing the Challenges of Creative Accounting (Manipulating Accounts)*". A theory study (2007).**

This study aims at identifying the concept of creative accounting and the motivations stimulating the companies to practice, as well as identifying all kinds and methods to practice it.

Accordingly, the researcher demonstrates some procedures which emerge from the Literature Review to curb those practices with a little clarification of the role of auditor in reducing the practice of creative accounting in order to reduce misinformation in the financial reports. Therefore, the study reaches to some findings, as follows:

1) Conducting more researches in the Arabic region to investigate the existence of creative accounting practices and the reasons behind such practices.

2) Professional organizations must develop methods of detecting creative accounting practices in order to get along with the steady increase in the cases of review failure.

3) Auditors must pay attention to developing training programs for workers at their offices to improve their performance in line with the rapid developments in the business environment.

Second: English Studies:

1. **KPMG study on "*The Role of Audit Committee in Overseeing Estimates and Accounting Provisions as well as Changes in Accounting Policies*," (2005)**

This study aims at identifying the factors which may affect the supervisory function of the audit committee concerning in preparing and stating financial. Thus, the audit committee, pursuant to the law of Sarbanes Oxley, supervises the preparation of financial reports, including overseeing policies and estimates as well as accounting provisions used by managements in preparing financial reports. Accordingly, the audit committee must get a clear understanding of the procedures used by the management and the procedures of decision-making and amendment, especially the procedures that can materially affect financial reports, in addition to how management assesses available accounting alternatives. This study, moreover, recommends that the requirements of affective supervision of the audit committee on financial reports are to communicate with both management and the external auditor. Hence, the study reaches to the fact that the affective communication ratios between the audit committee and the external auditor and management contribute in improving the effectiveness of financial reports procedures.

2. **(Gowthorpe & Amat) Study on: "*Creative Accounting: Some Moral Cases for Macro-Manipulation and Micro-Manipulation*" (2005)**

This study was conducted in Spain and aimed at analyzing two main kinds of manipulation; Macro-Manipulation and Micro-Manipulation. The former describes the influence on organizations and weakening their authority through forcing them to issue instructions go in line with preparers of financial statements. Whereas, the latter expresses the process of accounting figures processing which results in a viewpoint biased in favor of the company. The study, moreover, analyzed two kinds of manipulation from an ethical perspective and concludes that manipulation in the quality is an attempt to have creative accounts by preparers of financial statements which certainly lead to prepare financial statements achieving the objectives of preparers not users.

What distinguishes this study amongst all is that this one searches in the field of creative accounting, revealing its risk, methods, and the audit committees' role in figuring it out.

Chapter One

Creative Accounting,

Emergence and Concept

First: The emergence of creative accounting:

The history of manipulating accounting in values of business in the framework of principles and standards as well as accounting rules is related to the early eras of the Industrial Revolution, where manipulation processes happened during making cost calculation. This was because manufacturing and development of its methods created the need for what is now called (Industrial Accounting); and, thus the need for a specialized staff. Then, each business has the right to choose the appropriate accounting principles. However, the independence degree of the accounting work is weak; and thus, the degree of an accountant's influence on preparing financial reports is weak. In other words, the professional accountant's behavior in response to the aims and desires of managers, who has the right to evaluate the assets and the income, was restricted. In the eighteenth century, many facilities were merged with each other to create big and huge constructions; obviously, this led to the need to use the accounting system to avoid any accounting mistakes as well as prevent theft. (O'day, 2009, P:53)

Second: The Concept of Creative Accounting:

The concept of creative accounting is used to show the business's income, assets, and liability in an unreal way, which leads to many collapses and financial scandals in many major economic facilities, such as Enron, Worldcom, Harkin, and MerillEndico. Kamal Nasir has defined the creative accounting as the process of transferring financial accounting values from being real to desirable one, where the new values become advantages of the facility without manipulating any of the accounting rules and basics. (Kamal, 1993, P:33)

The creative accounting is a kind of tricks used in accounting methods to make companies look better than their previous situation in terms of their financial conditions, the amount of net profits, and their competition status in market.

Some companies resort to use the creative accounting, whenever their financial or operational circumstance is too bad and the executive management of the company refuses to disclose the real situation for many reasons. Therefore, such companies go on holding the flags of fake accomplishments rather than seeking reasons of deterioration and try to solve them.

Matar (2000) points out that the concept of creativity is used by some management of companies in an effort to reach to (unreal) improvement, in terms of profitability or financial position. This will be done through exploiting gaps existing in the audit methods or getting benefit from available alternatives in accounting policies, which the accounting criteria follows, especially in cases of measurement and disclosure followed in the preparation of financial statements.

He, as well, believes that most companies that use the creative accounting are those in trouble. This, he points out the auditor must pay much attention to procedures and unveil their effects, which influence financial indicators that are shown up in percentages, trends or averages….. etc.

It is noticeable that there are several definitions for the creative accounting; which all go in line with one definition as it is complicated, innovative and modern processes and practices that the accountants use their knowledge in accounting rules and laws to figure out recorded figures in the company's accounts to manipulate them in order to come up with certainly specific goals.

Hence, the researcher believes that the creative accounting is a follow of tricks and accounting excesses to show the concerned company in a better financial situation in terms of financial position or reducing the amount of profits for the purpose of tax evasion. Therefore, the creative accounting is a real transfer of figures from one status to another exploiting the flexibility of accounting rules and laws, with regard to personal estimates in particular.

Ahmad (2006) described such accounting as creative and innovative because it uses innovated methods in concealing or showing things not existed. In other words, innovative accounting creates events which are unreal and untrue.

The creative accounting as believed by Ismail (2008) is the legal use of principles and accounting rules in a way that helps in distorting financial statements as desired.

Grifliths in (1986) sees that procedures that business facilities use in order to lessen or increase their profit through formed and manipulated accounts to cover up violations and financial crimes; he considers it a great scam.

The researcher believes that creative accounting is a phenotype of profits due to accounting dexterity rather than the economic growth. The researcher, as well, believes that the creative accounting is a transfer of accounting values from their true image to untrue one to achieve specific aims that cannot be accomplished unless values are transferred.

The researcher, after reviewing all above-mentioned explanations and definitions of the creative accounting, noticing that there are some common denominators between all of the definitions as follows:

- Creative accounting (innovative) is a manipulation, fraud, and change of facts in a way of manipulating figures by legal exploiting in the profession of accounting.
- Creative accounting tries to achieve restricted personal benefit by transferring accounting values to fake values (unreal).
- Creative accounting is involved in the principles, criteria, and accounting rules; therefore, it is one of the legal practices but its findings and results are not true.
- Creative accounting cannot to be mastered unless the accountant has professional accounting capabilities enabling him to manipulate financial values and convert them to a desired form.

Reasons of Emerging the Creative Accounting:

The main reason for the emergence of creative accounting is a conflict of interest between various parties belonging to the company; the interest of managers is reducing taxes and profits, the interest of shareholders is maximizing the return of investments, the interest of employees is to increase various administrative compensations, and the interest of officials is to levy more tax.

What also contributes in the spread of creative accounting is the need for future expectation, esteem and personal judgment, optional accounting represented in accounting measurement alternatives, assessment, and disclosure, produced by accounting criteria, which influence the outputs of accounting system in the form or the content, in addition to the gaps found in the methods of outer audit.

Moreover, the differences of timing of some financial transactions as well as the differences of financial statements classification give managers chances to invent financial methods that can maximize the benefits of institutional or personal benefits, or both.

Here, the researcher believes that creative accounting can be called innovative and immoral holding the logo "No truth, nor reality, users unlimitedly create and create, and then they must manipulate by any available possible way to accomplish the company's interest." (Kamal, 1993, P:41)

Chapter Two

Creative Accounting:

Companies found out that laws adopted and applied do not grant what you need. Thus, the company cannot make profits, so it creates them instead.

- The conflict of interest is one of major factors causing the creative accounting. This conflict is between different categories of stakeholders in the company, such as the interest of the manager in reducing taxes, the interest of shareholders in maximizing profits and employees in increasing their salaries, and so forth. Therefore, the multiplicity of interest in spite of incompatibility is one of the main reasons behind the emergence of creative accounting.
- Alternatives of accounting measurement offered by the International Accounting Standards, which directly affect outputs system, and the gaps in the audit system, whether internally or externally; these factors help in the emergence of creative accounting.

Some goals of using creative accounting by companies:

- Some administrations resort to manipulation using creative accounting methods to achieve many goals, such as:

- Maximizing profits to make the manager and the company's board of directors to sell their shares at high prices, regardless of the damage that will prevail among other users.
- A way of convincing big companies to buy such company; therefore, the company will discard its current bad conditions.
- To increase the profits of the manager.
- To decrease the profits of the company to buy the shares of the company in the stock market.
- To build up further reserves.
- Tax evasion.
- To show that financial position is very strong to obtain loans.
- To increase investments in the company by attracting new investors.
- To sell the company at high prices if the sale is entered on the basis of assets appearing in the budget. (Asiri, 2002)

Accounts Auditor and Creative Accounting:

First: The Role of the Auditor:

In the light of the desire to fix the situation of some companies in the first place and to amend actions of management to accomplish balance between different interests in the company, a researcher believes – as a solution to the problem – that auditor is a part of the solution, where he looks at the audit task as a way to assist in improving the job in addition to strengthening basic controls; meaning that controlling the tools of control and presenting special operational effectiveness in strategies and administrative initiatives. Moreover, to enable the auditor to take advantage of the increasing growth in the demand of his services, the auditor himself needs to raise his organizational position as well as to adhere to the new framework in practicing his job as a partner for the management; bearing in mind that the auditor is the most important element that confirms the credibility of information. (Helmy, 2003)

- There must be an indication, based upon the significant role of the auditor, , where the task of auditor is related to the highest levels in the company. So, this task cannot achieve the highest degree of transparency and integrity because of the relationship that governs the audit system and of the lack of the entire auditor's independence. Accordingly, such an autonomy is very earthshaking because it enables the auditor to professionally perform his duty in an efficient and accurate way; therefore, the task must include the following:

- There mustn't be any impact on selecting the fields, activities, and administrative policy that must be examined by the auditor.
- There mustn't be any impact on selecting audit methods and procedures.
- There must not be any impact on showing facts in a transparent way in accordance with examination and audit process results. (Hamdan, 1993)

- The procedures of the auditor to put an end to the Creative Accounting (fraudulence):

First: Procedures relating to the income statement:

The aim of creative accounting in the income statement elements (revenues and expenses) is to help improve profit by showing fictitious profits (not real) via inflating sales or reducing expenses, or even both in order to improve financial ratios that include sales figures, cost, and net income in calculation as profitable percentages and efficient activity.

The most significant procedures in creative accounting in income statement are demonstrated as follows:

Sales:

The management of the company aims by using creative accounting at improving the number of sales in the income statements through increasing the number via phony sales. Hence, an indicator at such procedures is the unusual increase in sales in the previous years.

Thus, the auditor must be sure about bills, especially those deals carried out between parties relating to the company, like subsidiaries and associate companies.

Cost of sold goods:

- Managements head to lessen the cost of sold goods in the income statement in an attempt to increase profits. Then, the auditor needs to make sure that deals are real, not phony.

Operating expenses:

The management heads to increase such expenses then increase profits. Thus, the auditor has to make sure about the availability of capitalization terms, including expenses. (Al-Suhaili, 2006)

The result of discontinued activities:

The management aims at maintaining current profits level or increasing them. Then, the auditor needs to assess the impact of the closure of the production line as a result of the business.

Second: Procedures relating to the financial position:

The main goal is to improve the financial position through inflating value of assets or deflating values of commitments or both in order to optimize ratios derived from them, such as liquidity ratios, profitability ratios, etc.

Here is a presentation of the most significant procedures of creative accounting phenomenon which are related to a list of financial position and the reason behind conducting such appropriate procedures that the auditor will apply.

First: Procedures relating to cash:

The management heads to improving liquidity ratios; obviously the auditor needs to exclude restricted cash if liquidity ratio is calculated.

Second: Procedures relating to traded investments:

The administration, here, heads to increasing the value of current assets to improve liquidity ratio. The auditor, therefore, has to double-check prices range and real value of assets.

Third: Procedures relating to long-term investments:

The management aims at influencing the expense of investments in the company's notebook and outcomes of its business by showing profits share only without showing losses. (Kamal, 1993)

The auditor, in this case, has to make sure about this change by reporting and implementing income statement and financial position.

Fourth: Procedures relating to long-term assets:

The administration heads to improving the company's profits by including reevaluation surplus or by reducing expenses and depreciation. The auditor, therefore, must make sure about the safety and logical reevaluation and the actual amortization expenses.

Fifth: Procedures relating to commodity stocks:

The management, in such cases, heads to increasing the amount of commodity stocks in order to increase the value of current assets and influence liquidity ratios, then the auditor needs to examine the lists of inventory and verify the actual existence of the stock elements.

Sixth: Procedures conducive to intangible assets:

The administration, here, aims at increasing the values of company's assets to maximize profitability through lessening the amortization expense of assets. The auditor has to double-check bases used in the assessment and amend the value in accordance with the right bases.

Seventh: Procedures relating to traded commitments:

The management steers its way up and down to reach certain goals like reducing the value of current liability to improve liquidity ratios. The auditor, therefore, must verify the proofs of those values through traded commitments and re-calculate liquidity ratios. (Sameh, 1992)

Findings:

This study concludes the following:

1. One of creative accounting goals is giving a misleading impression about financial statements mentioned in financial lists and reports.
2. Creative accounting cannot be carried out and mastered unless the user is so intelligent, intellectual, and shrewd enough, who can always make use of accounting laws, exploiting gaps, and manipulating them the way he wants.
3. The one who can discover creative accounting methods and reduce its impact is the auditor, whether internal or external, who is well-qualified.

Recommendations:

The study comes up with:

1. Preparing and rehabilitating auditors, whether internal or external auditors, in a way that enables them to discover and fight creative accounting.
2. Spreading awareness of creative accounting among investors regardless of their type in order to be very careful whenever they choose a company to invest in.

3. The importance of finding out laws and regulations treating most legal gaps, such as principles and accounting criteria in order to stop exploiting such gaps.

4. Tightening up control over companies more effectively.

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