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Cosmetic Accounting: A Review of Literature and Perception of Accountants' in Nigeria

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Abstract
A scrutiny of the international scene over the past ten years has revealed various cases of corporate failure, facilitated by fraudulent manipulation of accounts by managers and with the implication of accountants in some instances. This manipulation is often referred to as cosmetic accounting. These cases have necessitated the examination of the consequences of these fraudulent practices. The study obtained primary data from accountants in Nigeria. Findings from the study show that respondents are aware of cosmetic accounting and that it is unethical. The results also indicate that the investors suffer as a result of decisions made using a doctored financial statement. Evidence also exist that management and auditors of corporate enterprises have a role to play in ensuring high business and ethical standards in order to guide against cosmetic accounting.
Keywords: Cosmetic accounting, public confidence, business failure, Nigeria

1. Introduction

The information provided by financial accountants is not an end in itself but a means to an end. The financial accountant provides information to various users of financial statements. Many of theses users have varying degree of information need. When accounting information gets into the hand of users, mostly shareholders and investors, among several stakeholders, it would have passed through several processes ranging from the involvement of the management personnel to board of directors duty in ensuring that the accounts of the company is prepared. In the process of making this financial information available to various users, the work of the auditor comes to play, particularly, in quoted corporate enterprises in Nigeria.

According to Jameson and Meckling (1976) on agency theory, the corporate enterprises are a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individual stakeholder are brought into equilibrium within the framework of contractual relations. However, the process of arriving at equilibrium can sometimes be bias given the various factors that affect the agents (stakeholders) investment in the process. Therefore, the conflicting needs of these agents can serve as a basis for understanding the cosmetic behaviour which is reflected in the financial accounts.

The word "cosmetic accounting" was recently used in Nigeria by Maduagufor (2008) in reporting that the accounts of some notable companies were muddled with financial report overstatement. He referred to this as an accounting offence which is often aimed at deceiving stakeholders, especially investors and financial analysts. Therefore, cosmetic accounting is synonymous to window dressing, earning smoothing, financial engineering or creative accounting (Amat *et al*.; 2003, Griffiths, 1986; Merchant & Rockness, 1994).

According to Smith (1992), much of the apparent growth in profits of corporate enterprises in the United Kingdom in the 1980s was as a result of accounting sleight of hand rather than genuine economic growth. He gave an example of a private company, Brentford Nylon, which collapsed shortly after reporting a profit of £130,000 sterling, but was later taken over by another company, Lonrho. This is one of the several scenario witnesses in cosmetic accounting. The question that readily comes to mind is that how can a company that reported financial profit during a particular period collapse shortly afterwards.

According to Sen and Inanga (2008), cosmetic accounting is not totally objectionable. However, when unethical elements and the motive are wrong, a negative intrusion is the outcome of the accounting details which become unreliable. Jameson (1995) noted that cosmetic accounting is aimed at manipulation, deceit and misrepresentation of financial statements. This, therefore, has a rippling effect on the decision making of investors. Naser (1993) also noted that auditors in United Kingdom and Spain have different views on cosmetic accounting. Thus, creative or cosmetic accounting is viewed differently. Hence, the need to look at the way it is viewed in Nigeria.

The objective of this study is to take a critical look at the literature on cosmetic accounting and assess accountants' perception of it in Nigeria. This research is expected to be of benefit to the various stakeholders in corporate enterprises. This includes but not limited to investors, financial analyst, auditors, management, researchers and regulatory authority.

This research work will also be of benefit to students of accounting. Since, students are groomed to become future accountants, this will open contribute to their knowledge on the implications of cosmetic accounting. Furthermore, this study will serve as eye opener to the practices of cosmetic accounting in corporate enterprises in Nigeria. The study will help in proffering solutions to the problem. Finally, it will serve as an addition to knowledge and a blueprint for regulatory authority.

2. Literature review

2.1 Conceptual framework

Accountants can use their knowledge of accounting rules to manipulate figures reported in the financial statements of corporate enterprises. This process is referred to as cosmetic accounting. In the United Kingdom, it is often referred to as "creative accounting" (Naser, 1993; Jameson, 1988 and Griffiths, 1986), in United States of America, it is called "earnings management" (Merchant & Rockness, 1994; Fisher & Rosenzweig, 1995). In essence, the concept of cosmetic accounting has taken up different names in the literature (See Figure 1).

Diana and Madalina (2008) noted that the development of economical and social activities as well as the stress of financial information users made the accounting innovation a necessity, hence, the development of creative accounting. The researchers noted that the development of creative accounting was encouraged by the alternative treatments permitted for solving one issue. Generally, an accounting issue can be solved in at least two methods, each of them with different effects on the company's financial position and performance.

Cyril (2007) and Omurgonulsen & Omurgonulsen (2009) suggested that creative accounting refers to accounting practices that seem to follow the letter of the applicable accounting standards but deviate from the spirit of those standards. The researchers noted that the motivation to indulge in these practices is anticipation of rewards which may include higher share prices, improved credit rating resulting in lower borrowing costs and higher incentive compensation for executive management. Some of the creative accounting schemes perpetrated by companies include improper revenue and expense recognition, faulty accounting in connection with business combinations, and wrongful use of off- balance-sheet arrangements. According to Gabriels & Vans (2008), these fraudulent schemes can be devastating to users like shareholders, lenders, employees, board of directors and other stakeholders. In order to understand cosmetic accounting better, Stolowy and Breton (2003) in its development of a framework for accounts manipulation, noted that classification is broadly into those within the limit of law and those outside the limit of law (See Figure 1).

2.2 Previous empirical findings

Naser and Pendlebury (1992) questioned senior corporate auditors about their experience of creative accounting. They were able to conclude that a significant proportion of all categories of companies employ creative accounting techniques to some extent. Many research studies examine a particular aspect or technique of creative accounting. All tend towards the conclusion that creative accounting using that particular technique does exist.

McNichols and Wilson (1988) modelled the nondiscretionary component of the bad debts provision. Barnea *et al.* (1976) discussed classificatory smoothing with the use of extraordinary items; their results, based on a study of sixty-two (62) United States companies, indicated that classificatory smoothing does take place. In a related study by Dempsey et al., (1993), the researchers found that managers showed a propensity to report extraordinary gains on the income statement and extraordinary losses on the retained earnings statement. Furthermore, this research found that the propensity to report in this way was significantly greater in non-owner managed firms.

Dascher & Malcom (1970) analysed data over several years for fifty-two (52) firms in the chemical industries sector relating to four income smoothing variables and their results were consistent with the hypothesis that deliberate smoothing had taken place. Amat *et al.* (2003) identified creative accounting practices in some of the thirty-five (35) large Spanish listed companies. Blake *et al.* (1998) and Diana & Madalina (2008) opined that there are different ways by which cosmetic accounting can occur. These are:

(i) The exercise of choice between permitted alternative accounting policies.
(ii) Application of bias in the making of accounting estimates.
(iii) Structuring of transactions in such a way to manipulate the financial statements.
(iv) Timing of genuine transactions so as to manipulate the financial statements.
(v) Performance based remuneration.
(vi) Emphasis on "bottom line wealth.
(vii) Emphasis on Earnings Per Share.
(viii) Emphasis on steady growth.

Therefore, the frequent occurrence of this practice makes users of financial statements to be worried because of the decision that they have to take using such statements.

2.3 Nature and consequences of creative accounting

The potential for cosmetic accounting is found in six (6) principal areas, some of which include timing of transactions and presentation of financial numbers. According to Mulford & Comiskey (2002) and Largay (2002), these areas are considered the "source of inspiration" for the creative accounting:

(i) Flexibility in regulation: With flexibility in regulations (e.g. in accounting standards), management can decide to change policies used in prior periods to a new policy without necessarily violating the standard. The study of Schipper (1989) noted that the management may decide the change of the policies, and these shifts are difficult to be identified a few years later.
(ii) The timing of some transactions
(iii) Lack of regulation: Accounting regulation is limited in some areas, for example in Romania there

is few mandatory requirements for transactions with futures and stock options or for the recognition and measurement of pension liabilities (Megan, n/d).

(iv) Management discretionary position: In order to obtain the financial position and stability they assumed; for example, the managers decide the increase or reduce of the provisions for bad debts (McNichols & Wilson, 1988).

(v) Artificial transactions: These are often used in order to manipulate the balance sheet amounts or to move the profits between accounting periods (Wang, 2007).

(iii) Reclassification and presentation of financials.

According to Niskanen & Keloharju (2000), the idea behind this behaviour is that humans may perceive a higher profit mark than a lower one. Caneghem (2002) also noted that some minor massaging of figures does take place in order to reach significant reference points. These manipulations are aimed to attracting investors and to appear profitable to the shareholders, employees, creditors, suppliers and other categories. However, when companies decide to misstate the financials, it can often lead to drastic consequences.

Diana and Madalina (2008) noted that the conflicts of interest among different interest groups represent the real causes of creative accounting. He noted that the managers are interested in paying fewer taxes and dividends, the shareholders in gaining higher dividends, the employees want to obtain better salary and higher profit share as well as the authorities desires to collect more taxes. These interests are conflicting and creative accounting is deepening it. Schiff (1993) has warned the investors that taking a company's financial statements at face value can be a recipe for disaster. He noted that creative accounting puts one group or two to advantageous position at the expense of others.

3. Methodology

Library and survey research design was used in for this study. This research strategy was considered necessary because of its ability to view comprehensively and in detail the objective set for the study. The library research was used majorly for the literature review while survey research design was used for obtaining accountants' perception. According to Spector (1981) and Denscombe (2003), this research design is an efficient way of collecting information from a large number of respondents.

4. Results

4.1 Perception of cosmetic accounting

From Table 1, it can be summarised that respondents are aware of cosmetic accounting (statement1) and that it is an unethical practice which can lead to business failure (statements 3 and 4). The results also indicate that the investors suffer as a result of decisions made using a doctored account (statement 4 and 10). Furthermore, it is believed that the management and auditors of corporate enterprises have a role to play in cosmetic accounting (Statements 2, 5, 9, 12).

4.2 Ranking of factors necessary in curbing cosmetic accounting

In order to curb cosmetic accounting and improve investors' confidence, the results in Table 2 show that management compliance with corporate ethics is very vital in achieving a good financial statement that investors can rely upon. Furthermore, ethical compliance of auditors is also rated as being important. Overall, business ethics and professional ethics should be imbibed to solve this problem.

5. Summary, conclusion and recommendations

5.1 Summary and conclusion

It is often the expectation of users of audited financial statements that the information contained there in, is true and a fair representation of the state of affair of the company. However, these expectations were dashed, following the several cases of corporate failures and loss of investments suffered by investors as a result of the fraudulent and unethical practices. Financial information made available to various users should be useful for decision making. In achieving this purpose, the work of the auditor comes to play.

Primary and secondary data were relied upon extensively in order to achieve the objectives set out for the study. The findings from the study show that respondents are aware of cosmetic accounting and that it is unethical. The results also indicate that the investors suffer as a result of decisions made using a doctored financial statement. Evidence also exist that management and auditors of corporate enterprises have a role to play in ensuring high business and ethical standards in order to guide against cosmetic accounting.

5.2 Recommendations

Following the findings of this paper, the following recommendations are been suggested in order to improve financial reporting process and public confidence in audited reports in Nigeria.

1. Auditors and managers need to strictly adhere to business and professional ethics in other to curb cosmetic accounting;
2. Regulatory framework should be strengthened; and
3. Strict penalty and punishment for erring managers and auditors.

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TABLE 1: PERCEPTION OF COSMETIC ACCOUNTING IN NIGERIA

	Statements	Mean Score	Standard deviation
1	Cosmetic accounting is not a new thing in Nigeria.	3.31	1.74
2	Management of corporate enterprises aid cosmetic accounting.	3.29	1.77
3	Cosmetic accounting is totally unethical.	3.96	1.04
4	Cosmetic accounting can lead to business failure	4.01	1.44
5	Auditors cannot easily detect a doctored account.	3.97	1.02
6	Cosmetic accounting is actually a blessing	2.65	1.68
7	Auditors have a duty to detect a doctored account.	3.72	1.22
8	The force of regulation in Nigeria is potent enough to curb cosmetic accounting.	2.88	1.54
9	Management intention to doctor an account is difficult to determine by auditors	3.87	1.53
10	Cosmetic accounting is used in deceiving investors.	3.68	0.74
11	Cosmetic accounting involves the illegal manipulation of financial statements.	3.29	1.37
12	It is not possible for Auditors to claim ignorance of a doctored account.	3.15	1.52

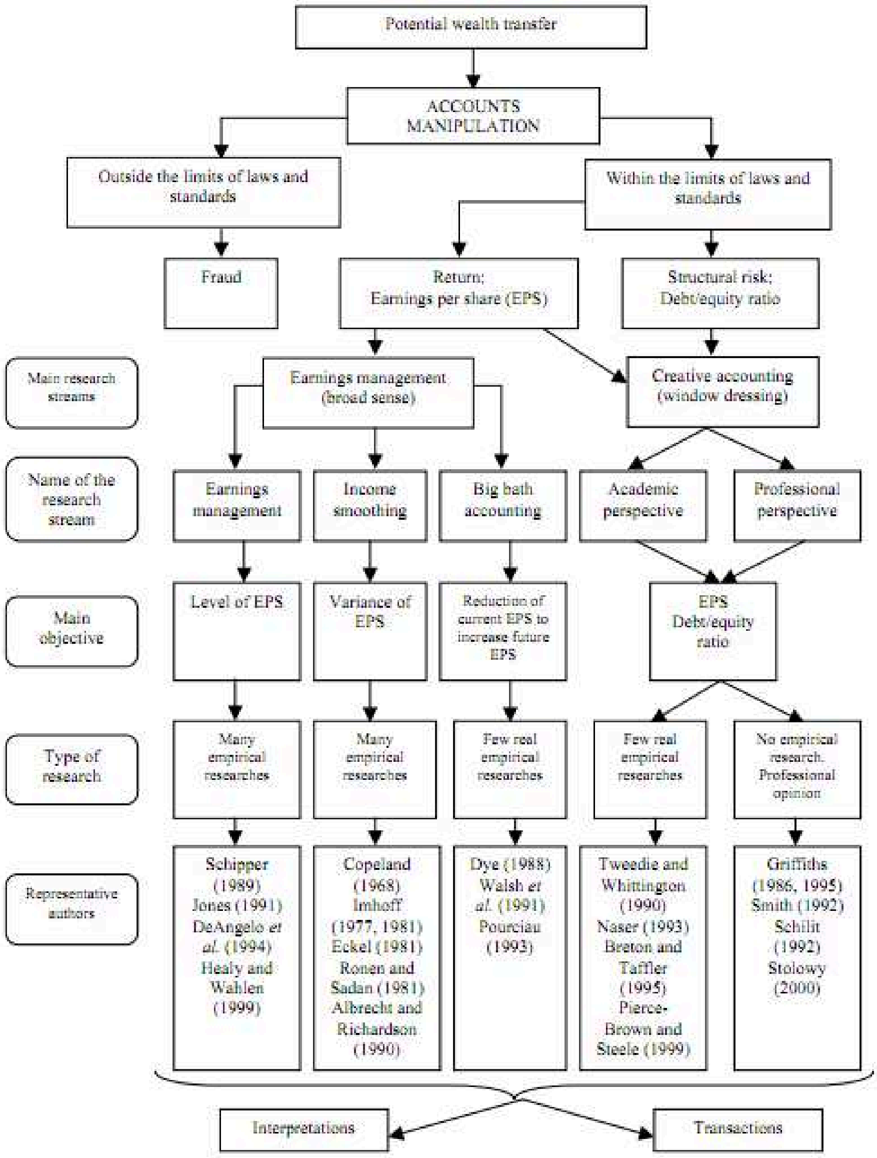
Source: Research Findings

TABLE 2: RANKING OF SOLUTION TO COSMETIC ACCOUNTING

Ranking	Factors	Mean Score	Standard Deviation
2	Auditors compliance with ethics	4.06	1.64
4	Strict penalty for erring companies and concerned individuals	3.62	1.78
5	Use of Forensic Accountants as an addition to audit attestation.	3.29	1.77
1	Management compliance with ethics	4.38	2.07
3	Improved regulatory oversight of companies	3.79	0.59

Source: Research Findings

Figure 1: Framework for understanding accounting manipulation practices by Stolowy and Breton (2003).



Source: Stolowy, H and Breton, G. (2003: 35), "Accounts Manipulation: A Literature Review and Proposed Conceptual Framework".