Creative Accounting

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The main function behind the conceptualization of creative accounting is maintaining the quality of financial reporting practice. Basically, creative accounting is the practice of influencing financial indicators through accounting knowledge without explicitly violating accounting policies, rules, and laws. Creative accounting is practiced to demonstrate the financial status desired by the company management wherein the stakeholders are informed what the management wants them to perceive. It facilitates the manipulation of financial information in its proper and accurate form in which the preparer uses the existing rules or in many cases ignores one or more rules.

ethical issues disclosure quality internal control

1. Creative Accounting Determinants and Financial Reporting Quality

It is generally seen that top management pressurize the accounting personnel in their banks to overestimate the financial state of their companies (Salome et al. 2012). As a result, accounting managers often manipulate the financial and accounting information to maximize the earnings of banks. These dishonest and manipulative practices benefit the shareholders since an increase is noted in the share prices of these listed banks. However, creative accounting practices can often lead to self-destruction, as a false disclosure of financial reports regarding the company's debt can mislead the public (Kardan et al. 2016). The different accounting engineering techniques which are implemented by the bank can help them present a desirable public image and portray a financial performance based on their specified preferences. This is done by exploiting legislative ambiguities. All these practices decrease financial data reporting quality. Hence, the banks that implement a higher level of creative accounting practices tend to possess a low or poor quality of financial reporting (Tri Wahyuni et al. 2020). The accounting managers of these banks, who carry out creative accounting practices, project a higher financial performance, better earnings, stock, and share prices (Goel 2014). In this study, the researchers have attempted to define some determinants which can affect financial reporting quality. This study can also explain the various manipulative practices which are implemented during the presentation of financial reports and their effect on the banking industry.

Ethical issues refer to right or wrong practices, based on an ethical viewpoint. The ethical issues implemented in an organization are important for the rejection or adoption of creative accounting practices. It has been argued that the tendency of some managers to focus on short-term gains is mainly responsible for an unethical environment in the bank, which further encourages poor financial reporting (Tassadaq and Malik 2015). However, when managers adopt ethical behaviour, accounting transparency in the bank can increase (Butala and Khan 2011). The acceptability and implementation of ethical behaviour had been examined amongst accountants, treasurers, and institutional investors (Cernusca et al. 2016). They observed that the treasurers significantly implemented creative accounting practices, whereas regulators and public accountants rarely carried out creative accounting practices (Ezeagba and Chidoziem Abiahu 2018). Charles et al. proposed a direct approach that suggested that managerial and corporate ethics affect the quality of financial reporting (Akenbor and Tennyson 2014). Thus, it can be concluded that an ethical environment and ethical management affect the quality of financial reporting.

The agency theory suggested that managers, who represent shareholders often indulge in creative accounting practices to maximize shareholder wealth. This theory stated that control mechanisms need to be carried out for protection of the shareholders against any conflict that affects their profit (Tommasetti et al. 2019). Hence, an information asymmetry is noted due to the profit conflicts occurring between the shareholders and managers. The people who follow the capital market seek reliable financial reports and data to decrease the information asymmetry occurring between the external investors and company management. Various researchers who investigated accounting practices stated that information asymmetry can be decreased by obtaining high disclosure quality (Song et al. 2013). Thus, disclosure quality was regarded as a major concept which helped in significantly decreasing profit and information asymmetry conflicts, thereby leading to an increase in the bank value (Yasser et al. 2016). A negative relationship is noted between information asymmetry and disclosure quality. Studies indicated that many banks do carry out creative accounting practices (Abed et al. 2020b).

Despite this, it is observed that a defined and an established internal control can decrease the auditing fees and improve the integrity and reliability of the financial reporting presented by the organization (Rozidi et al. 2015). These results showed that a weak, or lack of, internal control decreases the objectivity and quality of the financial reporting presented by the management. A positive correlation is seen between financial reporting quality and strong internal control (Ayagre et al. 2014). Furthermore, (Brauweiler et al. 2019) stated that the adoption of internal control is vital for improvement of the quality of financial reporting. The primary correlation occurs between the need for effective internal control and financial reporting quality (D'Mello et al. 2017). They explained the statements made by the former Chairman of the US Securities and Exchange Commission (SEC), who stated that the quality of financial reporting was determined by internal control. Thus, it could be concluded that an inefficient internal control causes a misstatement in financial reporting.

However, (Nagata and Nguyen 2017) noted that a better ownership structure can improve the external control on management, thereby improving the quality of the financial reporting. An ownership structure decreases the creative accounting practices; however, this effect is dependent on the size of the bank (Sahasranamam et al. 2019). According to (Alzoubi 2016), the ownership structure affects the quality of financial reporting in banks which use creative accounting indicators. In these banks, the agents use novel creative accounting techniques, which further decreases the quality of financial reporting. Furthermore, they stated that the ownership structure improves the financial reporting quality in organizations which use an accrual creative accounting indicator. Many earlier researchers have observed that the ownership structure of the banks showed a low efficiency when monitoring their agents (Kao et al. 2019). Other researchers also observed a positive effect of the ownership structure on bank performance (Bao and Lewellyn 2017). Additionally, the ownership structure positively affected the financial reporting quality (Han et al. 2019).

2. The Moderating Impacts of the Audit Committee

The impacts played by the audit committee have encouraged researchers to concentrate on financial reporting quality (Qian et al. 2015). Manipulation of the accounts causes an alteration in the share prices, and thereby the market capital of the company, which increases the risk of losing investors. In the past few years, the audit committee has played a vital role in the corporate governance mechanism (Saleem 2019). Some researchers have investigated the electiveness and competencies of the audit committee. However, many others believed that the existence of the audit committee was essential, as it can improve financial reporting quality (Buallay 2018; Al-Shaer et al. 2020). The audit committee had an impact on the determination of creative accounting (Inaam and Khamoussi 2016). It was significantly related to the quality of abnormal returns, accruals, financial restatements, and fraud.

Thus, ethics play a significant role in financial reporting as they are based on accounting standards. The ethical behavior of the employees in the organizations help to ensure that the organizations can gain the trust of the users with regard to the bank's services. Ethics allow organizations to determine right and wrong values. Following the right ethics ensures that organizations are not in crisis (Cernusca et al. 2016). It further indicates that organizations need to consider professional and societal ethics, and investigate how much the auditor can ethically detect creative accounting practices. Ethical issues related to creative accounting practices allow the audit committee to enhance their accuracy and efficiency in detecting fraudulent practices (Al Momamani and Obeidat 2013; de Jesus et al. 2020). Hence, the audit committee discourages any manipulation occurring in financial accounts. Thus, it was concluded that ethical issues regarding creative accounting practices were essential for financial reporting. Therefore, a fair and just attitude was essential while carrying out financial reporting (Voinea and Dimitriu 2014).

The organizations which are vulnerable owing to their industry and size are more likely to disclose information voluntarily to manage legitimacy, as audit committees vary due to the company size and sector, and can significantly affect the disclosure quality content (Mutuc et al. 2019). The effect of individual aspects of the audit committee characteristics can be seen in financial reporting quality (Saleem 2019). The audit committee promoted financial disclosure and its expert abilities promoted efficient financial reporting quality (Yekini and Jallow 2012; Mudel 2016). An independent audit committee was generally selected since this type of committee improved financial reporting quality (Qian et al. 2015). Hence, it is essential to investigate the effect of an audit committee on the correlation between the disclosure quality and the quality of the financial reporting presented by the organization.

An audit committee needs to regularly review the conclusions presented by the internal control department and ensure that the management of the company is acting on the recommendations of the internal control department in a diligent manner (Inaam and Khamoussi 2016). The internal control department is responsible for developing annual plans, and also submitting annual reports to the audit committee or company board (Brauweiler et al. 2019).

Hence, the audit committee and internal control department are motivated to release high-quality financial reporting. Moreover, it is believed that the audit committee and internal control department executed high-quality audit reports to prevent legal liabilities and maintain reputation. The primary function of an audit committee is to supervise the financial reporting quality and monitor the inclination of the company's management to implement creative accounting practices (Buallay 2018). Thus, organizations need to establish an internal control department using skills and resources which are vital and applicable to their size, complexity, and nature (Richman and Richman 2012).

Audit committees played a vital role in limiting creative accounting practices even though the ownership structure was controlled by a few people (Bajra and Čadež 2018). However, it was stated that the efficiency of these audit committees decreased if the ownership structure members belonged to or dominated the corporate boards. The influence of auditing committee characteristics on financial reporting quality has been examined (Saleem 2019). It was noted that the independence of the audit committee was related to a strong ownership structure function. An audit committee restricted aggressive creative accounting practices (Buallay 2018). An active audit committee provided effective monitoring, which improved the quality of the bank's financial reports (Deng et al. 2018). Banks with a concentrated ownership structure acquire good-quality financial reporting from an effective audit committee (Mutuc et al. 2019).

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