

Critical Examination of the Impact Accounting Ethics and Creative Accounting on the Financial Statements

Adel M. Qatawneh¹, Atala M. Alqtish¹

¹Associate Professor, Accounting Department, Faculty of Business and Administrative Sciences, Al-zaytoonah University of Jordan, Amman, Jordan

Correspondence: Adel M. Qatawneh, Associate Professor, Accounting Department, Faculty of Business and Administrative Sciences, Al-zaytoonah University of Jordan, Amman, Jordan

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Abstract

This study aimed to determine the impact accounting ethics and creative accounting on the financial statements in Jordan, the study importance arises from the need to recognize creative accounting and profession ethics for accountants, creative accounting can be used to manage profits, income smoothing.

Earnings management occurs when accountants use judgment in financial statements and in structuring transactions to alter financial statements to either mislead some shareholders about the underlying performance of a company, sometimes to impact contractual outcomes that depend on financial reporting.

To achieve the objectives of this study a questionnaire designed and distributed to the society of tax auditors and mathematical model built to link between creative accounting and accounting ethics percentage and some financial figures.

The statistical analysis showed that ethics and creative accounting had a positive impact on the financial statements.

Keywords: accounting ethics, creative accounting, financial statements, tax gap

1. Introduction

Creative accounting and accounting ethics and ethics one of the most recent subjects in the accounting field, and which considered as one of the main reasons of argument which face many concepts in accounting like true and fair of financial statement, and the earning quality from informational perspective.

Many researchers or writers try to get definition for this concept like (Naser, 2015) who give an academic view offers a definition “creative accounting and ethics is the transformation of accounting figures from they actually are to what prepares desire by taking advantages of the existing rules and/or ignoring some or all of them” this definition take one of the creative accounting and ethics sides, which related to the high flexibility and alternatives of financial rules and standards, but creative accounting and ethics does not stop hear, Jameson write about this subject as the following “The accounting process consist many of dealing with many matters of judgment and resolving conflicts between competing approaches to the presentation of the results of financial events and transaction” in our opinion this view look more wider Which mean that creative accounting and ethics may consist the judgments factor which can be used in a wrong way from some parties, so from previous we can see that we got many definitions of creative accounting, because according to our view there is no clear picture about creative accounting and ethics yet.

Accountants use their knowledge in the accounting rules and standards to manipulate the financial figures in the reported financial statements to get more favorable appearance for it, this process become considered as creative accounting, which was handled by many of studies from the theoretical or argument perspective, and rarely from empirical one. For that we try in our Research to view this subject from Empirical perspective, So this is put us in front of big question, which is “Do we got creative accounting and ethics in practice or not and even the answer Yes on No, how can we specify or get this answer?”

And what make this subject important as a research field. That creative accounting and ethics increased recently in a significant way. (Qatawneh & Afaneh, 2006)

we will try in this study to reach to a clear view of creative accounting and ethics and ethics in Jordan and to which extent it exist in the practice in Jordanian companies, and try to make a relation between some financial ratios or figures and the existing of creative accounting and ethics and ethics.

This view will be from a tax perspective which mean that we want to explain if the differences between the income presented by companies in reported financial statement and the adjusted income by ISTD, and try to know if the different caused by creative accounting and ethics or differences between taxes law and accounting standards (IFRS). (Qatawneh, 2012).

2. Study Problems

Due to the lack of researches addressing the critical examination of the impact ethics and creative accounting on the financial statements particularly in Jordan, this study attempts to answer the following questions:

1. What is the impact of accounting ethics on the financial statements?
2. What is the impact of creative accounting on the financial statements?
3. What is the importance of accounting ethics and creative accounting on the financial statements?
4. How does creative accounting impact on the financial statements?

3. Literature Review

Kamau, (2015), study the creative accounting of several companies in Kenya, the study was based on the theories, which were used to identify these practices, data was acquired through administering questionnaires and interviews, accountants, internal auditors and managers of companies publicly listed on the market. A sample of 39 out of a target population of 64 Companies listed was extracted from the market website. Analysis of variance (ANOVA) was used to establish if there is a statistical significance between the observed and expected amounts. Regression analysis together with the Pearson coefficient of correlation, were used to test hypothesis. The results showed the level significant impact on creative accounting among the companies listed on the market for practices such as Managements compensation, contractual obligation, and tax.

Qatawneh, (2013), investigate the effect of developing the international financial reporting standards and international standards on audit on the tax legislation in Hashemite kingdom of Jordan, This study found that there is a statistical evidence of the international financial reporting standards on the tax law, with the presence of some weak effect from the point of view of the research sample related to the fair value and the extent of its use in the investments, and the financial instruments. And there is no effect with statistical evidence of the auditing standards on the tax law, with the presence of some difficulties related to the evaluations and the future values which necessitate the auditor to take them into consideration during the audit.

The study recommended that is important to understand the necessity of the awareness for auditors with what's related to the importance of the most convenient planning and the importance of analytical revision in auditing activities with what corresponds with the goals on which auditing has been used in order to achieve harmony between IFRS and tax law. The necessity of awareness for accountants and auditors with the importance of the fair value and its impact on financial data and information through showing the financial data risks that are related to the application of the fair value and its effect on reporting financial statements and the accounting acknowledgement of financial data. The paper also recommended to Increasing the coordination and collaboration between the legal association of accountants and the income tax department for the purposes of standing on all the obstacles that occur without the acceptance of all the certified accounts from auditors in the patrol and without auditing from the income tax department.

4. Methodology

The previous empirical studies even it rare, like (John and others, 2005) study which, depend on asking direct question about the creative accounting and ethics like question: Do you consider the use of creative accounting and ethics to be a serious problem?, Do you consider the use of ethics to be a serious problem?

By this methodology they forget an important matter, which is, does the people who answer these questions get the knowledge and the right knowledge.

This means that there results maybe not correct, and this point becomes more important in our study because the education level and knowledge in this field is to narrow, especially that our questionnaire introduce to tax department auditor.

So if we want to get a real result about the existing of creative accounting and ethics and ethics in the Jordanian companies we have to get two main two things which is, the ability to separate between what it's creative and

what isn't, the second thing is get ability to monitor the real practice in the Jordanian companies.

This study consist two parts the first is monitor the practices of creative accounting and ethics and ethics throw ask the auditor about all the rejected transaction which they face when they make their assessment on the companies, from here we will get all the disagreement matters between the tax department and companies.

Then we take this case and develop it to questionnaire, also we add some points that we found it necessary to make the questionnaire more extent, like mention some point like, record revenue before it accrued, even it not possible in Jordan, and because most of the Jordanian companies try to reduce the tax expense by decrease the net income.

Also we add some points, which it exists in law as a disagreement matters with it. maybe our classifications to these cases which we get from assessors look argument, but it look better that ask about creative accounting and ethics in direct way , and get many views about the definition of creative accounting and ethics , and what is creative or not, which will effect on our results significantly.

Also it's important to mention that the nature of shenanigans in the Jordanian company focus on decrease the profit , not increase it , that not mean that we didn't mention points related to the creative practices which affect in the income and increase it.

As shown previously, the questionnaire will consist a group of cases cause the difference between the number of net income which present by the companies and the one which tax department apply, and we ask the tax Auditors two mention to which degree he face this case while he audit the companies.

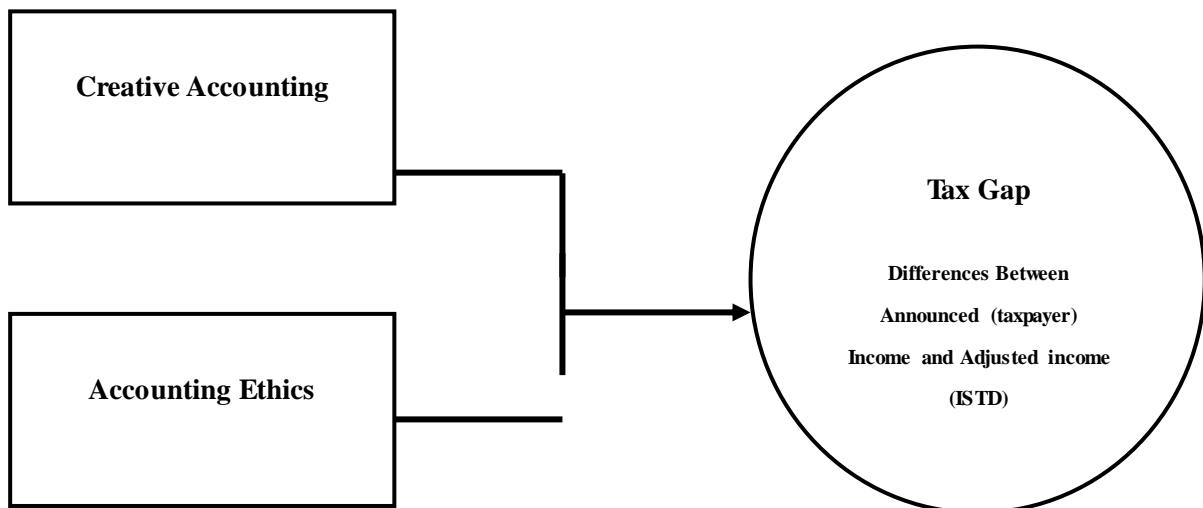
5. Hypothesis

After reviewing literature and some previous papers that related to the subject of this study, the researcher developed the following hypotheses to test them later to answer the questions for this study, draw some recommendations, present some finding based on the results of hypothesis testing.

H₁: Is creative accounting and ethics Cause the differences which exist between the net income that presented by company and other that adjusted by ISTD.

H₂: Is there a difference between International Financial Reporting Standards (IFRS) and taxes law cause the difference between the net income that presented by company and other that adjusted by ISTD.

We also can represent the previous hypothesis in the following chart:



In more details, we will analyze the questionnaire result to see the percentage of creative accounting, and then we will link between creative accounting and ethics percentage and some financial figures, so our mathematical model will be as the following:

$$Ca = b_0 + b_1 DBA + b_2 PRO + b_3 GRR + b_4 CFOP$$

The variables are:

CA: Creative accounting and ethics and ethics

DBA: Total Debt to Total Assets Ratio.

PRO: Net profit after Taxes.

GRR: Growth Rate.

CFOP: Cash Flow from Operation.

As following we will explain why we choose the above variables and the theoretical relation with existence of creative accounting:

Total Debt to Asset Ratio

We choose this ratio because it represent the percentage of Debt in companies, which mean that the possibility of non-real transaction become more and more, because the transaction that doesn't depend on cash bases, easy to manipulate with, so regarding that we see that forensic accountant try to detect these transactions.

We measure this variable as following.

Total Debt to Asset Ratio = short and long debt / total Assets

Net profit after taxes

Also we choose this variable because it well known that (especially in Jordan) that creative accounting and ethics activities increase when the net income become higher and higher, because management want always to pay less amount than it should be , this variable is calculated throw the income statement .

Growth Rate of the Company

As some researcher mention, the possibility of the existence of creative accounting and ethics increase when is there high and not expected growth rate in the firm or company, because they thing that creative accounting and ethics manipulate the fact to make it bigger and more favorable, so this will reflect on growth rate in significant way.

Any way we calculate this variable as following:

Growth rate = (market value for owner Equity + book value of liabilities)/book value of total Assets.

6. Questionnaire Design

In this Part we will explain all figures which included in the questionnaire, and reason behind classify it as Creative or not, but before that we will mention the main shenanigans types as mention by Howard schilit 2001

- 1- Recording Revenue too soon.
- 2- Recording bogus revenue.
- 3- Shifting future expenses to current period.
- 4- Shifting current income to later period
- 5- Boosting income with one time gain.
- 6- Failing to record all disclosed or liabilities.
- 7- Shifting current expenses to later period

Questionnaire items:

- Use IFRS method but differ with Taxes law like calculation and recording alternatives. This is will be the starting point to monitor the opinion of the person who will answer the questionnaire, and consist of the answer with the other cases.
- Recording expense of bad debts related to account receivables not accrued. This case is creative one, because it not allows even in IFRS or Taxes law, if we want to consider a debt as bad one it has to be accrued first and get other conditions also.
- Recording Revenues before the date of accrual, or not real one. This case related to point number one and goal to make inflated revenue and profit.
- Omit current revenues and shifting it to later periods. This transaction includes hide revenue figures and keeps related expenses, which will effect on the final result hardly.
- Change Inventory pricing method from period to another. This related to creative one , because change pricing method mean that company results will change , so when company decide to change pricing method for the inventory that mean it get benefit from that, which considered from many parties as kind of shenanigans.

- Record depreciation expense Related to unused Assets. This point consider as difference between taxes law and IFRS, because many methods of deprecation allow to record department. Expense even it used or not, but regarding to taxes law if the assets not used it not allow to record any depreciation related to it.
- Record expenses in the current period but in fact it related to later periods. This is one of the shenanigans and consists with point number three above kinds, and it allows even in or Taxes law.
- Recording mulct as expense. Taxes law rejects this point because it considered like expenses can be omit if the management work probably , but in IFRS it accepted because it's one of expenses kinds .
- Mix between capitalizing some expenses figures or considering it period expenses. IFRS get many alternatives in this field, so we can consider the same point as period expense or capitalize it, under what so called materiality, but according to taxes law, it limited by specific rules, even capitalize the figure or not, so we can say this point represent the differences between IFRS and taxes law.
- Record some allowances which is accepted by IFRS and rejected by Tax law. In IFRS allowances, record because it represent a reasonable perspective , but taxes law look at as a figure will create an expense toward it , so how we will record an expense without it exist , so the we got here difference in theoretical framework.
- Change the amount of ending inventory by change the price or quantity, especially under periodic method. Because as it known changing ending inventory effect on the cost of goods sold, so it probable to be a good place for shenanigans and creative accounting.
- Record expenses not support with probable expenses. This is creative one because this is meaning that we record not real expenses. Depends on more than one exchange rate in evaluating purchases or sales.
- Record salaries as expenses, but income tax not deducted from these salaries.
- Record training expenses and this training were internally generated.
- Record inflated salary expense like record not real one or inflate some figures.
- More than one exchange rate to evaluate purchases or sales. Because the exchange rate may change sometimes the results, because it mainly effect on cost of cost sold.
- Record Tax deducts able salaries, without deduct tax from it. This point consider as differences between Taxes law and IFRS , because in IFRS salaries consider as expenses even you deduct tax from it or not , but in taxes law to consider salaries as accepted expense you have to deduct tax from it if it tax deduct able.
- The use of unacceptable depreciation methods from taxes law perceptive. This point also consider as difference point because in IFRS you got many alternatives in deprecation method , on the contrary of taxes law which got only one deprecation method and consider accepted which is straight line method.
- Hide some revenue resources that refer to the firm and not recorded in books. This point creative one, because it rejected in both IFRS and Taxes law to hide some revenues or expenses.
- Shift accumulated loses for more than six years. Regarding Taxes law is rejected to shift loses to more than six years, but in IFRS there is no limitation on this.
- Record donations to other parties more than the actual payment. This consider as creative, because inflate the expenses more that on fact consider as manipulate of the fact of period expenses.
- Depend on low exchange rate to evaluate the purchases on the end of year, and then correct that price next year. This will change the cost of goods sold and then change the final result of period so this consider creative transaction.
- Inflate the salaries expenses by increase salaries amount, of number of employee.
- Consider some fees or salaries for foreign experts or something like that as apart from asset cost but not pay taxes for these salaries.
- Record expenses related to revenues not tax deduct able, and consider it relate to income resources that consider as tax deduct able. Here regarding taxes law you have to specify expenses regarding their Revenue source , this to some extent consider as agreed with matching principle , but also we have to know , that some alternative In IFRS that allow to you make what so called single step income statement which contain all Revenues on aside and all expenses on the other side , without specify which expense relate to revenue, but in taxes law you have to , because it deal with net profit for every Revenue source as separate figure.
- Omit part from ending inventory amount to increase the cost of goods sold. This will increase the cost of goods sold and decrease the net profit, this point is agreed to consider as creative transaction.
- Deprecate sold assets or depreciation expense become more than book value.

- Record expenses refer to external supplier, and transfer this amount to his bank in his country then reenter it to the company by partners accounts. Which mean that supplier not real, especially when there is no tax in his country, in this case he will retransfer the amount again, but will enter by the current accounts for? Partners, so by this transaction he increase the amount of expenses and get tax free with amount 25% even if he pay 10% tax on the previous transfer.
- Consider some export goods that included in export protocol as not included in the protocol.
- Increase non-real liabilities refer to Assets or expenses transactions.
- Record the shortage in Cash and it effect on cash account.

This point consider as differences between taxes law and IFRS, because IFRS allow to record an expense called shortage in cash in management accept that, but for taxes law this amount rejected and will get back to net income.

7. Results and Recommendations

Our results consist four parts, the first part include descriptive results, by get a percentage of how much creative accounting and ethics questions score to the total score of these questions, then we find the mean of these percentages, and we repeat it again for differences questions.

Regarding that the result was 65% for creative accounting and ethics and 55% for differences between taxes law and IFRS, which mean that the focus of answers was relate to creative accounting.

Also we notice the frequency of creative accounting and ethics question and it was like the following:

Details	Most frequent answer
Unreal expenses	Mostly
Increase revenues	Little
Decrease Revenues	Mostly
Record expenses not related for this period	Mostly
Shift current revenues to later periods	Medium
Manipulate ending inventory amount	Medium
Manipulate Firm Assets or liabilities	Medium

So we can notice that creative accounting and ethics shapes concentrate on Decrease revenues or increase expenses, on other words decrease net profit, regarding that we can say that creative accounting and ethics on Jordan focus on decrease the Tax expense and not on make financial statement more favorable.

The second part of our results refer to regression results, the result of mathematical model predict creative accounting and ethics with 35.5% which is good to some extent, and the main factor of this prediction was total liabilities to total assets, which mean than when the capital structure of the firm depend a lot on short and long Debts, the possibility for the existence of creative accounting and ethics increased.

On the other side we notice that the relation between net profit and creative accounting and ethics was negative, on other words the firms that announce about low profit more possible to use creative accounting.

The variable that not plays any role in prediction was growth rate.

The third part of our result relates forensic accountant methods we suggest some methods as methods to discover creative accounting and ethics and the result was like the following:

Method	Frequency
Comparative Numbers or Data	Always
Use other financial statement like cash flow	Always
Use external resources to get information	Always
Use analytical procedures, ratio etc...	Always
Assess the risk of audited figures	Mostly
Use samples in auditing	Mostly
Compare with other companies in the same segment	Medium
Use detailed auditing	Medium

These results meet our expectation of the methods that the assessor (forensic accountant) to discover creative accounting.

In the fourth part we try to arrange the accounts or financial statement regard how much it more possible to contain creative accounting, the results was as the following

Financial statements

1. Cost of finished good statement.
2. Income statement.

3. Balance sheet.

4. Cash flow.

Accounts:

- Inventory.
- Expenses.
- Revenues.
- Account receivables.
- Account payable.
- Assets.
- Cash.
- Others.

As we notice the most statement that contain creative is Cost of finished goods and this look logically, because if we look to accounts, we will see the inventory on the top of accounts, that contain creative accounting and ethics, also then second statement which is income statement, look sequence with accounts No. two and three, revenues and expenses, then we can say that the focus in Jordan in few on Balance sheet and the accounts relate with.

Lastly we recommend for future research the following:

- 1- The necessity of the awareness for accounting ethics and creative accounting with what's related to the importance of the most convenient planning and the importance of analytical revision in tax law with what corresponds with the goals on which tax auditing has been used in order to achieve harmony between IFRS and tax legislations.
- 2- Find clearer relation to link between the variables of this study and the existence of creative accounting, for the time being this is the only way to link between financial figures and creative accounting, but we thing it still have argument sides.
- 3- Try to find a clearer definition of creative accounting and ethics that can be translate into specific figures and say this consider creative and that not, we believe if we reach to that level, we can find the appropriate solution for creative accounting.
- 4- Increasing the coordination and collaboration between the legal association of accountants and the income and sales tax department (ISTD) for the purposes of standing on all the obstacles that occur without the acceptance of all the certified accounts from tax auditors in the patrol and without auditing from the ISTD.
- 5- The necessity of awareness for the tax and external auditors of income and sales taxes with the importance of international accounting standards.

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