An Examination of Financial Characteristics of Companies Involved in Creative Accounting Practice: Evidence from Developing Countries

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ABSTRACT

This study extends evidence on creative accounting and fills the gap in existing literature by examining the issue in developing countries. Taking Pakistan as a case study, the financial characteristics of companies, officially or publically identified for using some forms of creative accounting, are examined. Using a control sample of companies not identified for using creative accounting, financial ratios are used to analyse the dataset. The results show statistically significant differences in sample-control comparison of ratios. The Gearing ratio is statistically the most significant of all ratios as results achieve level of significance in all five years of analysis. Dividend payout ratio is the second most significant ratio. The two liquidity measures, current ratio and quick ratio, prove the least significant. This study provides evidence that financial characteristics, as measured by ratios, could be used as a tool to identify companies that are likely to be involved in creative accounting.

Key Words: Creative Accounting, Gearing, ICAP, SECP, Ratio Analysis

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1.0 Introduction and Background

The assertion that accounting can be used as a tool to achieve certain objectives of the preparer is quite significant (Pijper, 1993). Further, the possibility that financial reporting might be used in a creative manner has important implications for the users' ability to make economic decisions based on the information provided. The evidence is piling up that some companies regularly engage in the practice of the transformation of financial statement figures from what they actually are to what they desire them to be by taking advantage of flexibility and loopholes in existing rules and standards (Naser, 1993). This practice is popularly known as 'creative accounting' (Griffith, 1986, 1995; Jameson, 1988; Tweedie and Whittington, 1990; Breton and Taffler, 1995; Smith, 1992, 96; Naser, 1993; Walker, 1997, Pierce-Brown and Steele, 1999; Mulford and Cominskey, 2002; Schilit, 2002; Rabin, 2005). Although it defies an easy definition, creative accounting is introduced here as a practice undertaken to hide the reality of a firm's business health and prospects for the future, by presenting misleading or incomplete financial information by taking advantage of loopholes and flexibility in the existing accounting systems (Naser, 1993). Put it simply, creative accounting is a pool of accounting activities that may serve to hide the reality of financial statement figures and lead unsuspecting users to the making of wrong or misinformed economic decisions. The evidence in support of the existence of creative accounting is rapidly increasing (Gowthorpe and Blake, 1998), and so is the evidence that it has the potential to affect the users' ability when it comes to decision-making (Griffith, 1986, 95; Jameson, 1988; Pijper, 1993; Naser, 1993; Breton and Taffler, 1995; Pierce-Brown and Steele, 1999). It has been convincingly argued that excessive use of creative accounting puts in danger the primary purpose of the preparation of accounts (Wild, 1987) and presents a serious

threat to the integrity of financial reporting (Samuel et al, 1989). The high profile corporate scandals of Enron and WorldCom are examples to support this view.

2.0 Statement of Problem

A preliminary review of literature on creative accounting suggests that the issues of measuring creative accounting and assessing its impact need immediate attention. This issue is addressed by researchers in the UK and USA but it is still unaddressed in the developing countries. Among others, Breton and Taffler (1995) point out the following significant gap:

> *Where there is a voluminous literature exploring the relationship between accounting information and stock prices in general, appropriate research methodologies for measuring creative accounting and assessing its impact are lacking. (P. 81)*

Walker (1997) further strengthens the perceived gap by stating the following with regard to market-based research:

> *Market Based Accounting Research (MBAR) has provided evidence that the stock market is quite sophisticated in its response to accounting information. The idea that the entire market responds to accounting numbers naively has been firmly rejected. However, there is still disagreement about the degree to which the market is fooled by 'creative accounting'. (P. 344)*

This paper addresses the gap identified by Breton and Taffler (1995), however, there exists an opportunity to tackle the gap identified by Walker (1997). The major issue taken up is the assessment of the impact of creative accounting on the financial characteristics as measured by

financial ratios. The study will use a ready-made framework - the secondary data set of companies whose creative accounting practices have been publicly and/or officially disclosed. Thus, the main issue this study aims to investigate can be expressed as follows:

Given the financial statements of Pakistani companies whose creative accounting practices have been publicly and/or officially disclosed, this study proposes to identify and compare the financial characteristics of those companies that use creative accounting practices with those that do not use such practices; and to determine which of those characteristics are most consistent with the practice of creative accounting and which are not.

3.0 Literature Review

The existing literature on creative accounting is somewhat fragmentary. There is a lack of widely accepted theoretical framework on the issue. Although its origin can be traced long back, however, the literature specifically focusing on creative accounting doesn't emerge until the mid 1980s. The empirical literature, however, emerges in the early 1990s. The earlier work is in the form of textbooks which is widely accredited for creating awareness about the issue. Aligned with the research question, the literature that focuses on the characteristics of firms involved in creative accounting practice is of particular concern. Naser (1993) suggests that highly geared firms are more likely to use creative accounting to meet limits on borrowings and gearing as well as to bring stability in dividend paying policy. Smith (1992) provides evidence that companies trapped in financial difficulties used creative accounting to inflate their reported profits. Pierce-Brown (1997), however, suggests that companies violate GAAP and use creative accounting to decrease or defer rather than inflate profits. This argument is, however, subject to little evidence

compared to the traditional view that creative accounting is used to hide the poor performance and to inflate the profits (See for example, Smith, 1992). Pierce-Brown (1997) also suggests that industry is a good predictor of creativity. She identifies Hotel & Leisure, Water, Brewing, Media, Electronics, Industrial Materials, Engineering and Chemical as the most creative industries. Whereas, Insurance, Banks, Business Services, Electricity and Miscellaneous are identified as the least creative industries. Beneish (1999), based on empirical investigation of firms subject to a charge of earnings manipulation, concludes that such firms use creative accounting techniques to artificially inflate profit and deflate expenses. Peasnell et al., (2001) report that firms subject to FRRP enforcement are characterised by weak financial performance. On financial characteristics, they report that sample firms are (i) more likely to report losses and earnings decreases; (ii) more highly geared; (iii) less likely to sanction dividend increases; and (iv) more likely to provide optimistic forecasts for the year ahead. On non-financial characteristics, the sample firms are less likely to have (i) an auditor from the big 5 firms; (ii) an audit committee; and (iii) a high proportion of outside directors. The evidence supports the earlier work by Dechow *et al*. (1996) and Beneish (1999a) that firms subject to the Security and Exchange Commission (SEC) enforcement are characterised by poor performance in the violation year.

The existing literature, therefore, suggests that three aspects of a firm are more predictive of its creative accounting practice: Profitability, Gearing, and Liquidity (Smith, 1992; Naser, 1993; Beneish, 1999; Peasnell *et al*. 2001). This study also focuses on these three aspects as this will allow verification from developing countries. The selection of ratios to examine these aspects has been motivated by the three studies - Breton and Taffler (1995); Beneish (1999); and

Peasnell et al., (2001). Breton and Taffler (1995) uses financial ratios in their study to examine of analysts and brokers can correct for window dressed items. Beneish (1999) uses financial ratios to develop a model to identify companies involved in earnings manipulations. Whereas, Peasnell et al. (2001) uses ratios to study characteristics of companies reported to Financial Reporting review Panel (FRRP). This study uses financial ratios to identify and examine the financial characteristics of Pakistani companies. The selection criteria is that the ratio selected must have been used in one of the three studies mentioned above. The ratios used and their interpretations are given in Table 1 on the next page.

As mentioned above, this study relies on financial ratios to investigate the characteristics of sample companies. Horrigan (1965) asserts that one of the important development in accounting has been the formation of financial ratios for the purpose of analysing accounting data. It is unanimously accepted that financial ratios are used for all kinds of purposes (Barnes, 1987). Most of the studies quoted in the literature review also used financial ratios and accounting variables to investigate the use of creative accounting and motives behind its use. For example, Beneish (1999) developed a regression based on accounting variables to distinguish between companies manipulating earnings from those not manipulating it. Peasnell *et al*. (2001) also investigate the characteristics of sample companies by using ratios measuring liquidity, gearing and profitability aspects. Breton and Taffler (1995) also rely on standard ratios in their study to examine whether or not the analysts have the ability to calculate ratios that are potentially amenable to window dressing.

Table 1 - Selection of Ratios to Investigate Characteristics of Sample Companies

Ratio	Formulae	Breton & Taffler (1995)	Beneish (1999)	Peasnell et al. (2001)
Profitability/Investment*:*				
Operating Profit (OP) Ratio	operating profit/sales	*		*
Return on Equity (ROE) Ratio	net profit/equity	*		
Return on Assets (ROA) Ratio	net profit/total assets	*	*	
Dividend Payout (DP) Ratio	dividend per share/earnings per share			*
Book value per share (BVPS)	net assets/no of shares	*		*
Gearing/Liquidity:				
Leverage Ratio (LR)	total debt/total assets		*	*
Gearing Ratio (GR)	long term debt/ long term debt + equity	*		
Current Ratio (CR)	current assets/current liabilities		*	
Quick Ratio (QR)	current assets - stock/current liabilities	*		
Working capital to total assets (WCTA)	working capital/total assets		*	

(*) implies that this particular ratio is used in this study

4.0 Methodology

The general research method adopted for this study is the case study method with emphasis on one particular country, Pakistan. While the case study method is normally associated with a qualitative methodology, it is appropriate in this study (beneath a positivistic, quantitative umbrella) because of the highly-structured nature of the data to be used and the fact that the results are easily replicable. The timeline for the study is clearly cross-sectional rather than longitudinal. The aim of the study is to provide a cross-sectional slice of current creative accounting practices in Pakistan. As for the data, there is no need in this case to attempt to acquire original data directly from the firms being examined. The data already exists in terms of companies whose creative accounting practices are public knowledge.

4.1. Selection of Sample Companies

The validity of the results largely depends on the validity of the data set. Considering the limitations of developing and using an empirical definition of creative accounting, this study uses the data set of companies whose creative accounting practice is either officially or publically disclosed. There are some studies of late that have investigated the characteristics of the firms officially and/or publicly disclosed for defective accounting, violating GAAP and misrepresenting their accounts. For example, Dechow *et al*. (1996) examined the causes and consequences of earnings manipulation for a sample of firms subject to enforcement actions by the Security and Exchange Commission (SEC) of USA. Beneish (1999) investigated the incentives and penalties related to earnings overstatement by violating GAAP. Peasnell et al.

(2001) investigate the characteristics of the firms subject to the adverse rulings by the Financial Reporting Review Panel (FRRP) in the UK. The FRRP has the same responsibility and authority in the UK that the SEC has in the USA. In a similar study, Hines et al., (2001) evaluate the experiences of directors and the auditors of the companies given enforcement rulings, with the Financial Reporting Review Panel (FRRP).

Two sources in Pakistan have been identified as likely to be able to provide the required data in a form that would be useful for this study. The first source is The Institute of Chartered Accountants of Pakistan (ICAP) whose members adjudged a certain number of companies for not giving true and fair view of business performance and/or not complying with the Generally Accepted Accounting Principles (GAAP). The auditor's report is an independent, authentic and authoritative opinion that states whether or not, (i) company accounts have been prepared in accordance with the provisions of the Companies Act and Generally Accepted Accounting Principles, (ii) the profit and loss account and the balance sheet give a true and fair view of the company's financial position and performance, and (iii) the accounts are free from any material misstatement (Hatherly, 1997). The second source is the Securities and Exchange Commission of Pakistan (SECP) who issued adverse rulings or ordered enforcement actions against a number of companies for irregularity and misrepresentation in their reported accounts. The SECP is a prime regulatory body charged with the responsibility of ensuring the quality of financial reporting in the country.

Upon contact, the Director Technical Services of the Institute of Chartered Accountants of Pakistan (ICA) and Director Enforcement of the Security and Exchange Commission of Pakistan (SECP) provided the required information. The ICAP has started collecting data about auditors'

reports which are "other than clean" from the accounting period that ended in 2000. The ICAP has confirmed that, in 1999-2000, their members issued 126 'other than clean' reports on the published financial statements of the listed companies. This is significantly a large sample size taking place in a single year. The ICAP, however, does not have any prior such data and number of companies given such a report after 1999-2000 is quite small and insignificant. The ICAP could only provide a list of 88 companies. All subsequent efforts to obtain a full list were unsuccessful. The analysis period is 5 years from 1996 to 2000. The later is the year when the two samples were emerged.

The SECP was created on January 01, 1999 after a revamping of the Corporate Law Authority (CLA) of Pakistan. Since its incorporation and until 2000-2001, the SECP has ordered investigations into the poor performance and other irregularities for 9 listed companies. It has further issued directions in the cases of 11 listed companies to fix certain irregularities in their transactions, which have adversely affected the interests of minority shareholders. This provides two sizeable samples –

ICAP Sample 88 companies

SECP Sample 20 companies

The control samples have been formed separately by matching each company in the SECP Sample and each company in the ICAP sample with another company, which:

a) belongs to the same Industry;

b) is similar in size in terms of total assets or market capitalization;

c) has not been given either enforcement rulings by the Securities and Exchange Commission of Pakistan (SECP) for misrepresentation of its financial position and performance; or 'other than clean' report by the member of the Institute of Chartered Accountants of Pakistan (ICAP).

4.2. Data Analysis Methods

The statistical tests used are Descriptive Statistics and Wilcoxon Sign-Rank Non-Parametric Test. The former aims to provide a feel and description of the data set. The Wilcoxon Signed-Rank Test is employed to evaluate the significance of differences between the sample and control data. The impressive advantage of this test is that it makes no assumption with respect to the data distribution (normality is not required) nor homogeneous variances (comparable variances not required) as the t-test for the comparison of paired data set. Unlike less robust nonparametric tests such as the sign tests, the Wilcoxon signed-rank test is used to determine the magnitude of differences between matched group. It is also useful to determine more than only the direction of difference.

5.0 Results and Discussion

Table 2 presents the results of analysis. It lists *p* values of Wilcoxon Signed-Rank Test for all ten ratios used to examine the research question. Overall, the two creative accounting samples, ICAP and SECP, exhibited statistically different financial characteristics from their respective control samples. The differences were exhibited in all the 5 years of analysis. The most

Table 2: Sample-Control Statistical Significance for ICAP and SECP Samples as indicated by *p* value – The Results of Wilcoxon Signed-Rank Test

Ratios	**1996**	**1997**	**1998**	**1999**	**2000**
ICAP - OP	0.14	0.010*	0.44	0.97	0.83
ICAP - ROA	0.09	0.003*	0.25	0.90	0.92
ICAP - ROE	0.10	0.005*	0.26	0.96	0.92
ICAP - DP	0.009*	0.002*	0.06	0.001*	0.001*
ICAP - BVPS	0.17	0.90	0.47	0.25	0.28
ICAP - CR	0.98	0.53	0.37	0.03*	0.11
ICAP - QR	0.49	0.96	0.21	0.07	0.18
ICAP - GR	0.001*	0.001*	0.001*	0.001*	0.001*
ICAP - LR	0.90	0.52	0.25	0.02*	0.001*
ICAP - WCTA	0.88	0.33	0.89	0.96	0.98
SECP - OP	0.53	0.09	0.05*	0.008*	0.03*
SECP - ROA	0.94	0.49	0.87	0.87	0.59
SECP - ROE	0.62	0.46	0.91	0.59	0.46
SECP - DP	0.58	0.07	0.26	0.14	0.86
SECP - BVPS	0.49	0.01*	0.009*	0.43	0.001*
SECP - CR	0.52	0.80	0.79	0.46	0.15
SECP - QR	0.92	0.32	0.25	0.11	0.25
SECP – GR	0.002*	0.01*	0.001*	0.003*	0.001*
SECP - LR	0.001*	0.04*	0.001*	0.31	0.15
SECP - WCTA	0.98	0.006*	0.11	0.03*	*0.004

* significant p value at 5% level of significance

significant year was 1997 when the sample-control comparison was significant in case of 9 out of 10 ratios. The next significant years were 1999 and 2000 when the difference was significant in case of 7 out of 10 ratios. This was the pre Musharaf period where the economy of the country was relatively stable and growing under the Nawaz Sharif's Government. The young and ambitious companies were likely to revert to creative accounting to keep abreast with the growth and expectations. For ICAP data, the most informative and significant measure of sample-control difference was the Gearing Ratio (GR) that reached significance level in 5 out of the 5 years of analysis. The next best was Dividend Payout Ratio (DP) in which case the comparison was significant in 4 out of the 5 years of analysis. For SECP data, the most significant measure of difference was again the Gearing Ratio (GR) achieving level of significance in 5 out of the 5 years of analysis. The second most significant ratios were Operating Profit Ratio (OP), Book Value Per Share (BVPS), Leverage Ratio (LR) and Working Capital to Total Assets (WCTA).

All these measures of differences proved statistically significant in 3 out of the 5 years of analysis. However, due to small sample size of SECP, it is hard to conclude the significance of these results. Interestingly, Dividend Payout Ratio (DP) that was significant in ICAP data found insignificant in SECP data. Another interesting finding was that the two liquidity ratios. Current Ratio and Quick Ratio, both proved to be insignificant measures of difference with Quick Ratio comparison failing to achieve level of significance in any single year of analysis both for ICAP as well as SECP data.

Within the limited scope and scale of the study parameters, the data analysis thus supported and confirmed that the firms apparently engaged in creative accounting practices exhibit significantly different financial performance characteristics than those which are not so engaged. Overall,

results support the existing evidence regarding the financial characteristics of companies engaged in any forms of creative accounting practice. Although results were significant for almost all the ten financial ratios, however, the users of creative accounting showed higher values in respect of gearing and leverage ratios. This is consistent with Naser's (1993) findings that highly geared firms are more likely to use creative accounting to meet limits on borrowings and gearing as well as to bring stability in dividend paying policy. This also supports the findings of Beneish (1999) and Breton and Taffler (1995). The least informative found to be the two liquidity measures, current ratio and quick ratio. This leads to the conclusion that creative accounting is a tool used to affect the long term aspects of the business. The higher values of profitability ratios for the creative accounting samples support Smith's (1992) assertion that companies trapped in financial difficulties use creative accounting to inflate their reported profits. Beneish (1999) also provided empirical evidence that firms use creative accounting techniques to artificially inflate profits and deflate expenses. This view, however, contradicts with Brown (1997) who claimed that companies violate GAAP and use creative accounting to decrease or defer rather than increase or inflate reported profits. Pierce-Brown's (1997) view is subject to little support compared to the traditional view that inflating the reported profitability is one of the major motives behind the use of creative accounting. Pierce-Brown (1997) also suggested that industry is a good indicator of use of creative accounting suggesting that manufacturing industries are more likely to use creative accounting and the services industries are less likely to use such practice. Looking at the composition of the two samples, ICAP and SECP, it is quite clear that the two samples are widely representing the manufacturing industries. The results partially support and partially contradict the findings of Peasnell et al., (2001)

regarding the financial characteristics of companies subject to enforcement rulings by the Financial Reporting Review Panel (FRRP).

The Wilcoxon Test suggests that the Gearing Ratio is the most significant and informative of all the ratios used to measure the differences between the ICAP and SECP samples compared to their respective Control samples. Interestingly, the statistical significance is achieved in five out of the five years for both ICAP and SECP samples and their respective control samples. On the basis of results shown in Table 3 it can be conferred that the companies using creative accounting practice are likely to have higher gearing ratios compared to the companies that do not use creative accounting. This supports the view that 'managing gearing position' is a likely motive behind the growing use of creative accounting. The results also verify findings of some of the key studies covered in the literature review chapter. Naser (1993) did find in his survey among the auditors and accountants that management of gearing ratio is the top most objective of using creative accounting. Gearing was also a key ratio in study by Breton and Taffler (1995). Gearing ratio was a key variable in the analysis model used by Pierce-Brown and Steele (1999) and Beneish (1999). The later was particularly important as it applies model based on ratios to examine the characteristics of companies that violate generally accepted accounting principles (GAAP). This finding confirms the assertion that creative accounting is a tool that is employed with the same motives and intentions in developing countries as it is employed with in the developed countries. This also suggests that the gearing aspect of a business may be the focus of policy makers and standard setters working to curb the use of creative accounting.

Table 3: Gearing Ratio - Comparison of sample (s) versus control (c) data: results of the Wilcoxon signed-rank-test for difference between sample and control (*: exploratory significant p-values. rejection of zero hypothesis of no difference)

ICAP	s1996	c1996	p<0.001 ***	n=86
	s1997	c1997	p<0.001 ***	n=86
	s1998	c1998	p<0.001 ***	n=84
	s1999	c1999	p<0.001 ***	n=86
	s2000	c2000	p<0.001 ***	n=86
SECP	s1996	c1996	p=0.002 **	n=17
	s1997	c1997	p=0.01 *	n=17
	s1998	c1998	p<0.001 ***	n=17
	s1999	c1999	p=0.003 **	n=17
	s2000	c2000	p=0.001 **	n=17

6.0 Conclusion

In general, it can be concluded that Pakistani companies that practice creative accounting (as indicated by the 'other than clean' designation in ICAP sample, and the misrepresentation of accounts in SECP sample) show many substantive and significant statistical differences when compared to control samples, i.e. companies that have not been thus flagged. These differences can be used to help determine whether specific firms are using creative accounting methods to enhance the general financial outlook being presented to the public. They can also serve as a way to 'red flag' firms for further study and examination. The statistically most significant measure of difference between the two samples and their respective control samples has been 'gearing ratio' and the most least significant source has been the two liquidity ratios. The results support the findings of Naser (1993), Breton and Taffler (1995) and Beneish (1999) who found gearing as a significant variable of creative accounting practice. This also leads to the conclusion that creative accounting is used to affect long term aspects of a business, gearing in this case, and

not the short terms aspects, liquidity position for instance. The study does not strongly support the earlier evidence that creative accounting is a tool solely used to improve or inflate profitability position (for example, Griffith, 1986 and Smith, 1999).

The study results have shown that creative accounting practices do have an impact on companies' evaluation and that there are some significant statistical differences between companies that engage in such practices versus those who do not. While the study did not directly examine the impact on the country's economy, it only stands to reason that damage to the reliability of economic and financial information cannot have any positive effects on the economy—and that any effects will be more obvious in the economy such as Pakistan's which does not have the same sophistication and safeguards as more developed economies do.

In the context of above, the study does contribute to existing knowledge by adding evidence from developing countries. One more positive contributory note, the study's successful implementation of the research methodology shows that a quantitative methodology can be applied to the determination of creative accounting's existence and its effects, real and potential. That alone should be able to counteract some of the pessimism, cynicism and scepticism that have become pervasive in the developing country markets regarding the actual performance of companies. It is hoped that further work along this line may eventually lead towards the development of a model that could help easily spot creative accounting.

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