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Cosmetic Accounting Practices in Developing Countries: Bangladesh Perspectives

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Cosmetic accounting is a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business. This study expresses the views of External Auditors, Internal Auditors, and the Accountants on causes, techniques, effects and solution for Cosmetic Accounting. To achieve these purposes total 108 respondents have been surveyed. Findings from descriptive statistics reveal that the perceptions of three categories respondents are different about the various aspects of cosmetic accounting .It also shows the opinions of internal auditors, external auditors and accountants raised some concerns as to whether these circumstances will last.

Field of Research: Accounting.

Keywords: Cosmetic Accounting, External Auditor, Internal Auditor, Accountants.

1. Introduction

Creative accounting is referred to also as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting. The preferred term in the USA, and consequently in most of the literature on the subject is 'earnings management', but in Europe the preferred term is 'creative accounting' and so this is the term that will be used in this paper. It should be recognized that some accounting manipulation involves primarily balance sheet rather than earnings management.

Definitions of creative accounting vary, and include 'Is the deliberate dampening of fluctuations about "some level of earnings considered being normal for the firm" (Barnea et al. 1976).

'Is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental'. (Merchant and Rockness, 1994).

'Involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared'(Copeland, 1968). Schipper (1989) observes that 'creative accounting' can be equated with

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'disclosure management', 'in the sense of a purposeful intervention in the financial reporting processes.

The term creative accounting is widely used to describe accepted accounting techniques which permit corporations to report financial results that may not accurately portray the substance of their business activities ... creative accounting is recognized as a synonym for deceptive accounting. Creative accounting methods are noteworthy because they remain in use as generally accepted accounting principles, even though they have been shown to be deceptive in many cases (Metcalf, 1977: 188). Every company in the country [UK] is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted ... this deception is all in perfectly good taste. It is legitimate. It is creative accounting (Griffiths, 1992: 1).

Authors like Stolowy and Breton (2003) are among the few interested in the subject of creative accounting daring to suggest a theoretical framework for the understanding of the accounting manipulation practices. The fundamental principle which their theoretical framework is based on is the following: the aim of publishing financial information is that to reduce the costs of the enterprise projects financing. But this reduction depends on the risks to transfer the riches as they are perceived by the agents on the market. The practical means to operate these transfers are based on the results and the balance between the debts and share capital. Consequently, the purpose of accounting data management is to change these two measures: the variation of the result per share and the relation liabilities/assets. The result per share can be changed in two ways: either adding or subtracting certain profits or expenses (which represents the change of the net result) or transferring a column from the upstream or the downstream of the results serving as a computation base of the result per share (which is the management through classification). Regarding the relation between liabilities and assets, this can be modified by increasing the benefit or hiding certain financings with the help of engagements generating devices, off the balance sheet.

In the context of the world economic crisis nowadays, creative accounting will be referred to more often as a field from where it is expected either to offer live-saving solutions or be blamed for all the negative evolutions. On this aspect, Salustro and Leburn (2000) would say: „Crisis periods are actually trials for entreprises; affecting their cash flow and generating risks, that accounting doesn't deal with in a flawless manner. Therefore, managers are tempted to resort to ingenious, more often questionable procedures, for refining accounts presentation." The reality of an enterprise can be mirrored in several aspects, starting from the atmosphere and the environment where the employees perform their daily activity, through the company's brand and to the yearly financial statements. This reality, though, seen from the perspective of the external environment, capitalized in clients, suppliers, public institutions, banks, investors etc, is strongly influenced by the subjectivity of the one watching (Balaciu, et al.2009).

The rest of the paper is structured in four sections. Section 2 discusses prior conceptual aspects of creative accounting, while section 3 analyses why some academicians consider it as blessing and also its causes, techniques and effects. Section 4 concludes the study by providing some solutions.

2. Research Question

Whether there are differences in perceptions about the causes, techniques and effects of cosmetic accounting among the company accountants, internal auditors and external auditors in Bangladesh?

3. Literature Review

The creative accounting appeared in the Anglo-Saxon literature in the 1970s, most often in the papers about the bankruptcy of enterprises and those written by Watts and Zimmerman (1978, 1986, 1990) which represent the foundation of the positive accounting theory. This research trend made the object of several empirical works trying to explain the accounting choices starting from the problem of the political costs that the enterprises are exposed to. More recently, Brown and Steele (1999) have selected a portfolio of 12 accounting techniques, combining also the accounting options with the management decisions. In addition to the political costs, it is emphasized the importance of the activity and risk sector and that of the firm operation, as significant determinants of the creative accounting.

As a journalist, Griffiths (1986) noticed that the majority of the economic entities hide their benefits. He appreciates that the financial statements are drawn up based on the “embellished” registers, the resulted figures being changed in order to protect the guilty. Creative accounting is presented as a legitimate fraud.

From practitioner’s perspective, Jameson (1988) appreciates the fact that accounting process in its essence, requires the operation with different motivations, different ideas. From this diversity arise manipulation, cheating and falsification at some less scrupulous accounting members. It is he who states that these creative accounting practices do not break the law or the accounting standards; therefore they comply with the law but not its spirit. Jameson states thus the negative character of creative accounting which distorts the enterprise’s financial results and the position, misleading the users of the accounting information.

From the perspective of a financial analyst, Smith (1992) considers that the highest part of the economic growth of the ‘80s is “due” to creative accounting that is to the accountants’ skills than rather to a real economic growth. In the book, Accounting for Growth, he motivates the previous idea, exemplifying the cases of some British companies which use creative accounting practices (finding concrete proofs at 45 economic entities of great Britain), taking the example of three companies which experienced the financial collapse shortly after they had presented their financial statements which clearly reflected: financial stability.

Although there are misunderstandings regarding the definition of creative accounting, the majority of researchers accept the idea that this stands out through two aspects. The first aspect has in view the use of the accounting professionals' imagination in order to translate those juridical, economic and financial innovations for which there are no normalized accounting solutions at the time of their occurrence. The second aspect shows the fact that the adjustments resulting from this financial engineering are initiated according to their incidence on the enterprise's balance sheet and results (Balaciu, et al.2009).

Creative accounting, as a matter of approach, is not objectionable *per se*. However, when unethical elements make intrusion, the resultant accounting details become anything but true and fair. Creativity in such context is like referring to a half glass of water as half-full instead of describing it as half empty. While both statements are factually correct, they paint different pictures and thus convey different images. Creativity in company accounting may arise under at least *three* different financial market conditions. The first is when a company floats its shares to attract investors to subscribe to such shares either at par or at a premium. The second is when the company whose shares are already listed in a stock exchange, wants to paint an attractive picture of its financial conditions. Finally**,** a company having its shares listed in the stock exchange may declare and pay high dividends based on inflated profits through overvaluation of assets, undervaluation of liabilities and change in systems of stock valuation that may boost the image of the company at least in the short run. Unethical considerations in creative accounts have developed to such depths that terms like *fraud audit* and *forensic accounting* have gained currency and are becoming new professions. Accounting practitioners and auditors are increasingly required to appear in courts for deposition (Sen and Inanga, 2001).

Creative accounting puts into practice in recent years not only in Bangladesh but also in a lot of developed countries. However, it is marked that the level of window-dressing of company financial statements in some developing countries has significantly desecrated all known ethical standards. This study focuses on this issue extensively relating to Bangladesh considering the perceptions of external auditors, internal auditors and accountants.

4. Objectives of the Study

- To overview the concepts of cosmetic accounting.
- To explain why cosmetic accounting is considered as blessing or curse.
- To describe the causes, techniques and effects of cosmetic accounting.
- To suggest some recommendations on the basis of opinions of respondents.

5. Methodology of the Study

The study presented in this paper is an exploratory one, based on both primary and secondary sources of information. The secondary sources include published books, journals, periodicals, reports and newspaper. The study's population was limited to: (1) 36 chartered accountants (2) 36 internal auditors and (3) 36 accountants on the convenience basis. For the purpose of analysis, the collected data have been tabulated in five tables using mean. The study period was from August to October, 2010.

6. Analysis of the Findings

Financial statements ordinarily provide information about the financial performance, financial position, and changes in financial position that is useful to a wide-range of users in making significant investment and other economic decisions. But the practice of cosmetic accounting has been a constraint in disclosing true and fair view of the state of affairs of an enterprise in most of the countries. In Bangladesh, it is evident from the interviews of internal auditors, external auditors, and accountants serving in organization that the practice of cosmetic accounting has been continuing since the emergence of financial reporting. Most of the respondents think cosmetic accounting started in Bangladesh from the emergence. Some think from 3 decades, 2 decades, 1 decade and some think it is a new concept (Appendix-1).

Cosmetic accounting could be a blessing or a curse. This practice can be considered as a blessing when it contributes to refine the existing accounting system. It becomes a curse when this technique is used unethically to exploit a specific group of users of financial statements. This study reveals that 61% of the respondents treat cosmetic accounting as both blessing and curse. Only 10% of the respondents think this technique could be a blessing, and 29% of the respondents think it as a curse.

Table 1: Perceptions about why cosmetic accounting is considered as blessing

Sl no.	Blessings	Internal auditor	External auditor	Accountants
1	To stay at par with forecast and actual	3.4722	3.7778	3.8333
2	To stay at par with industry best performers	4.6389	3.4722	3.5833
3	To attract more stakeholders into business	3.6111	3.8333	4.4444
4	To maintain stability in the share price at stock exchange	3.5556	4.0833	4.9444
5	To maintain the trust and reliability of the subsidiary's as a parent company	3.3333	3.8333	3.1944
	Grand mean	3.7222	3.7999	3.9999

Most of the accountants believed that "to stay at par with forecast and actual" cosmetic accounting is mostly desired. While the external auditors gave next importance to it and the internal auditors commented the least on it.

Most of the internal auditors responded that "to stay at par with industry best performers" was the reason for adapting the cosmetic accounting while in this arena the accountant respondent comparatively less importance than the internal auditors while the external auditors thought the least.

Most of the accountants viewed as the main aim for the adoption of cosmetic accounting is to attract more shareholders into business, while in response to this question the internal auditors gave less importance while the external auditors responded moderately to it.

One of the focus questions of this study was "Do the prospectuses issued by the organizations of Bangladesh ignore "notes to financial statements" as well as the information required by BAS/IAS, specially in regard to disclosures and accounting policies?" Most of the respondents agreed with this issue. But also different views have been found (Appendix-2).

Another important question of this study was whether the use of cosmetic accounting is a legitimate business tool or not. Most of the respondents disagreed with this issue. But also different thoughts have been found (Appendix-3).

Various research studies have identified a number of causes of using cosmetic accounting techniques. Hepworth (1953) identified that tax avoidance, reporting stable earnings could be one of the important cause or motivation for the use of cosmetic accounting. Income smoothing can also be a motivation for using cosmetic accounting particularly in countries where conservative accounting system is practiced. Big bath accounting can be another motivator for the use of cosmetic accounting where a company making a bad loss seeks to maximize the reported loss in that year so that future years will appear better.

Cosmetic accounting is also used to match reported earning to profit forecasts. This is practiced when a company can not attain its profit target.

Creative accounting may help maintain or boost the share price both by reducing the apparent level of borrowing, so making the company appear subject to less risk, and by creating the appearance of good profit trend. (Amat and Gowthorpe-2004, available on-line at: www.econ.upf.edu/docs/papers/downloads/749.pdf).

Healy and Wahlen (1999) identified the reason for using cosmetic accounting technique to minimize the gap between the actual performance of the firm and analyst’s expectations.

Another set of reasons for creative accounting, applies to all companies, arises because companies are subject to various forms of contractual rights, obligations and constraints based on the amounts reported in the accounts. (Amat and Gowthorpe-2004, available on-line at:www.econ.upf.edu/docs/papers/downloads/749.pdf).

Table 2: Perceptions about the causes of using cosmetic accounting

SI No.	Causes of Cosmetic Accounting	Internal auditor	External auditor	Accountants
1	To avoid tax and dividend	3.9722	4.3889	3.9167
2	Income smoothing- to show uniformity	3.8056	3.9167	3.3889
3	Big-bath accounting- not showing inflated figures	3.4722	3.5556	3.5000
4	To minimize the gap between the actual performance of the firm and analysts' expectation – i.e. the budgeted	3.6944	4.1111	4.0833
5	To minimize the executive compensation which is linked to income measurement- like fringe benefits	3.4167	3.3611	3.2222
6	To reduce the perception of variability in underlying the profit of the firm.	3.6111	3.6389	3.6389
7	To boost the share price in the Stock Market.	3.6944	3.9444	4.1667
	Grand mean	3.6667	3.8452	3.7024

In response to the causes of cosmetic accounting practice most of the external auditors responded that they agreed in order to avoid the tax and dividend because they perhaps practice this. While the internal auditors were second in this regard and the accountants were third in position. To avoid tax and dividend is viewed as main concern to the external auditors followed by internal auditors and accountants.

Most of the external auditors responded that they agreed in order to minimize the gap between forecast and actual. Where in this regard the accountants also highly agreed and were ranked second, the internal auditors were ranked third in this issue.

In response to the survey question "in order to boost the share price in the stock market" cosmetic accounting was regarded as a relative tool to most of the accountants, while the external auditors were positioned second and the internal auditors third.

The potential for creative accounting is found in six principal areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgment in respect of assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers. (Largay, 2002).

Accounting regulatory bodies in most of the countries allowed companies to change their accounting policies. For instance, IAS permits a company to show their assets either at revalued amounts or depreciated historical cost.

Management can exercise their discretion in estimating significant items in the financial statements, for example bad debts provision.

The timing of recognition of a transaction can also be a technique of creative accounting. There are some areas of accounting in which accounting regulation is limited, for example accounting for stock options, environmental costs.

Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods. (Amat and Gowthorpe-2004, available on-line at: www.econ.upf.edu/docs/papers/downloads/749.pdf).

Reclassification and presentation of financial numbers are another technique of cosmetic accounting. Gramlich (2001) suggests that firms may engage in balance sheet manipulation to reclassify liabilities in order liabilities in order to smooth reported liquidity and leverage ratios.

Table 3: perceptions about the techniques using for cosmetic accounting

Sl No.	Techniques of Cosmetic accounting	Internal auditor	External auditor	Accountants
1	To show hidden pension liabilities	3.2500	3.2500	3.2500
2	To assetize expenses instead of writing them off	3.6389	3.8611	3.4444
3	To show receivables or inventories growing faster than sales – thus enhancing current assets in the balance sheet	3.5556	3.7500	3.3889
4	To show negative cash flow to avoid incidents of demanding higher emoluments from employees	3.0000	2.8889	2.9167
5	To consolidate owned subsidiary's income and net worth as a mean to reflect better financial position	3.2500	3.8056	3.4444
6	To follow conservative practices and be consistent in practice	3.7500	3.5000	3.6667
	Grand mean	3.4074	3.5093	3.3519

Most of the external auditors responded that to consolidate owned subsidiary's income and net worth as a technique to reflect better financial position is the main reason for this technique to be used. While in this response the accountant was placed next and the internal auditor in last.

Most of the external auditors agreed with the view that to show receivables or inventories growing faster than sales – thus enhancing current assets in the balance sheet was most important factor to consider the cosmetic accounting as a technique. Here also the accountants were placed second and the internal auditors were in third position.

While most of the respondents in the internal auditors category agreed to the survey question that "to follow conservative practices and be consistent in practice" was the main reason for this technique to be implemented, the accountants responded as second and the external auditors were third in position.

Sen and Inanga summarize the speech of Jim Kennan, presented before the Australian Society of Accountants, which identified some significant effects of creative accounting. First, there are companies listed on the stock exchange, which show inflated profit and better financial position in their creative accounting statements to attract investors; this creation of accounts just misguides and creates confusion.

Second, some company prospectuses may not always depict the reality of the financial positions of the listed companies.

Third, processes adopted for created accounting statements may hold out untrue hopes to investors for a shorter period but cannot continue to succeed for a longer period.

Ultimately, the concerned companies listed in the stock exchange collapse and the investors lose confidence in them and stock market. (Retrieved from *http://web2.msm.nl/news/articles/050707papers/0206_Sen_Inanga.PDF*

Table 4: Perceptions about the effects of cosmetic accounting

Sl No.	**Effects of Cosmetic accounting**	Internal auditor	External auditor	Accountants
1	Tax and dividend avoidance	4.8056	4.2222	3.8889
2	Minimization the gap between the actual performance of the firm and analysts' expectation – i.e., the budget	3.8056	4.0000	3.8611
3	To attract investors showing enhanced profit	3.4722	3.9722	4.1667
4	Minimization the executive compensation which is linked to income measurement..	4.1944	3.0556	3.0278
5	To consolidate owned subsidiary's income and net worth as a mean to reflect better financial position	3.2778	3.4444	3.3889
	Grand mean	3.9111	3.7389	3.6667s

The internal auditors were the highest in rank to the question that the effect was most seen in order to avoid tax and dividend. As the internal auditor is part of top management, it is obvious that they believe it is an effect of cosmetic accounting. The external auditors were second in this category and while the accountants were placed third.

The internal auditors respondents were again at top to the question that the effect of cosmetic accounting in minimization the executive compensation which is linked to income measurement. It is not surprising because internal auditors are part of the top management and policy makers. In this category the external auditors were placed second and the accountants were placed third.

Perhaps the most effect of cosmetic accounting was in this question that to attract investors showing enhanced profit, the accountants were placed top regarding this where the external auditors were placed second and the internal auditors were third.

The foregoing parts of the paper demonstrate that various techniques of creative accounting are in practice. The accounting standards setting authority and other regulatory bodies such as Securities and Exchange Commission, Government must develop ways to detect and prevent the dangers of creative accounting. Punitive measures must be taken by the respective regulatory bodies. Sen and Inanga (2001) suggest that a country needs to have a sound, strong stock market as the foundations of free and fair enterprise system. Ethical codes need to be given much importance by the accounting profession. Fraudulent financial reporting has to be prevented by all means.

Scope for choice of accounting methods can be reduced by reducing the number of permitted accounting methods or by specifying circumstances in which each method should be used. Artificial transactions can be tackled by invoking the concept of “substance over form”, whereby the economic substance rather than the legal form of transactions determines their accounting substance. (Amat and Gowthorpe-2004).

The use of management discretion in estimation can be regulated or minimized by developing standards. Finally, ethical standards and governance codes must be properly enforced in the corporate world.

Table 5: Perceptions about the solutions of cosmetic accounting

Sl No.	**Solutions for Cosmetic accounting**	Internal auditor	External auditor	Accountants
1	Scope for choice of accounting methods can be minimized	3.8889	4.1944	4.0278
2	There should be uniformity in practicing judgmental issues	3.6111	4.0556	4.2778
3	Artificial transactions can be tackled by invoking the concept of materiality	3.6667	3.8611	3.7500
4	Introduction of forensic accounting as a measure to investigate the fraudulent practices	4.1111	3.9722	3.9444
5	Giving greater importance to ethical codes by the accounting profession	4.0833	4.1389	4.1667
6	Punitive measures by national accounting bodies, courts and Govt.	3.9167	4.2500	3.8611
7	A very soundly constituted stock market and SEC.	3.9444	4.1944	4.1667
	Grand mean	3.8889	4.0952	4.0278

Most of the accountants agreed and were ranked as first to the response that there should be uniformity in practicing judgmental issues, the external auditors were ranked second here and the internal auditors were placed third.

Most of the external auditors agreed to the question that scope for choice of accounting methods can be minimized as a solution for cosmetic accounting and thus was placed first in this response. While the accountants was placed second and the internal auditors was placed third.

A very soundly constituted stock market and SEC was a solution for cosmetic accounting in response to this question. It is the external auditors who ranked first followed by the accountants and finally the internal auditors.

7. Limitations of the Study and Scope for Further Study

This study is based on few structured questionnaire in survey and some secondary data. Only perceptions have been considered but what are the reasons behind it have not been concentrated. If the sample size was large, the finding might be different. This study lacks consideration of the clear idea of all questions towards justification of their responses. Also merely Bangladesh perspective about creative accounting has been considered. Therefore, the global issues are absent in this article where some different result could be discovered. That prospect is kept open for further research.

8. Conclusions

The concept “creative accounting” assimilates various definitions in the literature and it is examined under two important viewpoints: a positive one and a negative one. Creative accounting offers an alarming confront to the accounting profession. The problem is an international one, with accounting policy choice being a particular problem for both developed and developing countries. There is a wide variety of motivations for managers to engage in creative accounting. Accountants who accept the ethical challenge those creative accounting raises need to be aware of the scope for both abuse of accounting policy choice and manipulation of transactions.

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Appendix-1

Practice of cosmetic accounting	Internal Auditor	External Auditor	Accountant	Total
Emergence	17	27	12	56(51.9%)
3 decades	1	0	1	2(1.9%)
2 decades	1	1	4	6(5.5%)
1 decade	0	2	3	5(4.6%)
New concept	17	6	16	39(36.1%)
Total	36(33.33%)	36(33.33%)	36(33.33%)	108(100%)

Appendix-2

BAS/IAS	Internal Auditor	External Auditor	Accountant	Total
Strongly agree	6	6	4	16(14.8%)
Agree	8	10	12	30(27.8%)
Neutral	8	1	2	11(10.2%)
Disagree	13	15	9	37(34.3%)
Agree	1	4	9	14(12.9%)
Total	36(33.33%)	36(33.33%)	36(33.33%)	108(100%)

Appendix-3

Legitimate	Internal Auditor	External Auditor	Accountant	Total
Strongly agree	1	0	5	6(5.5%)
Agree	4	5	5	14(13.0%)
Neutral	2	7	12	21(19.4%)
Disagree	24	16	12	52(48.2%)
Agree	5	8	2	15(13.9%)
Total	36(33.33%)	36(33.33%)	36(33.33%)	108(100%)