

# Chapter 5

## Theoretical Analysis of Creative Accounting: Fraud in Financial Statements

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### **ABSTRACT**

*This chapter begins with the definitions of creative accounting, fraud and financial statement fraud and explains the relationship between them. Next, it presents the classical theories on the determinants of financial statement fraud. Section 1.4 presents the profile of accounting scandals. Section 1.5 presents the components of financial report fraud as well as the parties involved in creative accounting. Section 1.6 presents the reasons and motivations for creative accounting. Specifically, the authors analyse manipulation practices, the methods and the opportunities for creative accounting and address why financial frauds occur. Finally, they offer conclusions in Section 1.7.*

### **1.2 EXPLORING THE TERMS**

#### **1.2.1 Definition of Creative Accounting**

While creative accounting is the widely used terminology, no agreement has been reached on its exact definition. There is a widely used definition that was used by Mulfors and Comiskey, (2002) in the U.S.A. with a quit smaller definition that was practiced in U.K. In the following table, the two representative definitions of creative accounting have been presented.

United States meaning of creative accounting includes fraud which is omitted in U.K as it takes for granted the use of accounting flexibility. This thesis adopts the definition of creative accounting of Jones (2011). As Jones (2011) argued, “the flexibility in accounting opens the door for many different methods of creative accounting”. Thus, it is perceived as legitimate accounting flexibility use in accordance with the interests of the preparers, hence not illegal. Creative accounting utilizing firms are not violating the law, as they use accounting flexibility to promote its interests.

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## **Theoretical Analysis of Creative Accounting**

*Table 1. Definitions of Creative Accounting*

<b>Year</b>	<b>Definition</b>	<b>Authors</b>
<b>Narrow Definitions of Creative Accounting</b>		
<b>2005</b>	'The exploitation of loopholes in financial regulation in order to gain advantage or present figures in a misleadingly favourable light.'	Oxford Dictionary of English
<b>Wide Definition of Creative Accounting</b>		
<b>2002</b>	'Any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, both within and beyond the boundaries of generally accepted accounting principles, and fraudulent financial reporting. Also included are steps taken toward earnings management and income smoothing.'	Mulford andComiskey (2002)
<b>Preferred Definition of Creative Accounting</b>		
<b>2011</b>	'Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interests of the preparers not the users.'	Jones (2011)

Creative accounting is formed by taking advantage of the ambiguities in the present regulatory system to work towards the interest of the “preparers” and not that of the “users”. Economic reports of listed firms in Europe are demanded to put forward account report fair and just. In many countries there is a dominant belief that accounts must truly depict economic reality. The users are assumed to be provided with a series of economic accounts that depict financial reality. On the contrary, creative accounting favours the interests of the preparers (for instance, those of the managers). This is likely to happen because of the economic reports’ basic need to be adaptable so as to give a precise image of the accounts.

No creative accounting occurs with inflexibility, as one of the ultimate purposes of accounting is to offer shareholders vital facts that ensure shareholders create economics related decisions regarding shares. While regulatory structure varies in different countries, the framework sets is aimed at providing a true and fair view to shareholders. More so, elasticity offers managers with creative accounting. While managers may not be breaking laws, they are deviating from basic ethics of accounting and may be participating in fraud.

### **1.2.2 Definition of Fraud**

The boundary between fraud and creative accounting is not always clear. Fraud is normally decided by the courts or regulatory authorities. However, as previously stated, companies, uses creative accounting whilst ending up getting involved in committing fraud. Thus, it is essential to define fraud and analyse the difference between creative accounting and fraud. No definite definition of financial fraud exist, therefore, the table presents some definitions of fraud.

### **1.2.3 Types of Fraud**

While creative accounting was used within regulatory structure, fraud works outside regulatory framework.

In every country, fraud’s definition differs. However, it essentially comprises violation of the regulatory framework and/or breaking the law. Individuals or a management can be involved in committing the act of fraud. In case of individuals, the accounting fraud would, in general, involve theft of” assets,

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