Creative Accounting : Ethical Perceptions among Accounting and Non-Accounting Students

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Abstract

This paper seeks to investigate the level of ethical awareness, as well as the attitude towards creative accounting, among accounting and non-accounting students of the post-Enron generation. Creative accounting is in essence not illegal and investors may sometimes even benefit from its application. However, creative accounting distorts reality, which may mislead users of financial statement information and is therefore generally considered unethical. We presented students with a list of statements concerning specific creative accounting situations. Our results show that accounting students tend to find creative accounting less acceptable than non-accounting students. They also seem to have a stronger ethical awareness, which may be the result of accounting ethics courses. However, we do not find a significant relation between students' attitude towards creative accounting and their personal ethical orientation. This is in contrast to prior research on the ethics of earnings management. Moreover, we do not find significantly different opinions for men versus women in our study. Again, this contradicts the results found by earlier research and suggests more homogeneity among the next generation of professionals.

Keywords : Creative accounting, earnings management, ethics, Enron, education

JEL-code : M14 & M49

Introduction

This paper seeks to investigate the level of ethical awareness, as well as the attitude towards creative accounting, among accounting and non-accounting students. Furthermore, we control for differences between men and women, as well as perceived ethical orientation. The ethical awareness question is extremely relevant these days as recent scandals question the ethics of business managers and auditors. This paper is, to our knowledge, the first to report on the perception of creative accounting ethics among accounting students of the post-Enron generation. They witnessed through the media how Enron and other firms used creative accounting to cover up major debts and how investors were misguided by overstated profits. Instead of merely investigating students' general attitudes towards ethics, we clearly focus on one specific theme, creative accounting, which is closely related to the profession these students are about to enter.

Naser (1993) defines creative accounting as '(1) the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practices in them to transform financial statements from what they should be, to what preparers would prefer to see reported, and (2) the process by which transactions are structured so as to produce the required accounting results rather than reporting transactions in a neutral and consistent way.' Jameson (1988) describes creative accounting as 'a process of using the rules, the flexibility provided by them and the omissions within them, to make financial statements look somewhat different from what was intended by the rule. It consists of rule-bending and loophole-seeking.'

Creative accounting is in essence not illegal and investors may sometimes even benefit from its application. For instance, earnings management may guarantee a constant dividend policy. However, this technique can be considered unethical and should be avoided because it distorts reality. It should be clear that it is a thin line that separates legal creative accounting from management fraud. Moreover, it remains difficult to put down general rules of ethical behavior, as one culture may consider something as ethical, while another might reject it completely. The diversity of ethical frames of reference implies that no global ethical standard can be put forward as this would suggest the preference of one frame of reference over another (Loeb, 1978).

Our research is perhaps most closely related to Elias (2002) who relates ethical orientation to the ethics of earnings management as perceived by accountants, faculty members and students. In contrast to Elias (2002) our focus is not limited to one specific aspect of creative accounting, namely earnings management. Secondly, our respondents have recently witnessed accounting scandals in their home country such as Lernout & Hauspie and Sabena. In 2000, it was exposed how Lernout & Hauspie Speech Products inflated its sales by approximately 70%, which eventually led the firm to bankruptcy. The case received extensive media attention because many small private investors lost their money. Recently, KPMG, whose audits allegedly violated generally accepted accounting and auditing principles, agreed to pay $ 115 million to settle a class-action shareholder lawsuit (Public Accounting Report, 10/15/2004). Sabena, the Belgian airline which was part of the Sairgroup, filed for bankruptcy in 2001. Investigations into the accounting practices at the Sairgroup showed that specific accounting choices had resulted in a more favorable presentation of financial performance for years. (Jorissen and Otley, 2004).

Our research is well embedded in the accounting and business ethics literature that studies ethical behavior in general among accounting or non-accounting students and professionals. Fulmer and Cargile (1987) studied whether senior accounting students who have been exposed to a professional code of ethics in the classroom are more or less likely to view business practices in ethical terms than other students. Their results indicate that differences indeed can be found with accounting students tending towards a more ethical viewpoint, although these differences are in perceptions rather than actions. Cohen, Pant and Sharp (1998) tested for the influence of differences in gender and discipline on ethical evaluations, intention and orientation among students. They showed that women had consistently different ethical evaluations, intention and orientation than men and found some evidence that accounting students have other ethical perceptions than students in other disciplines. Landry, Moyes and Cortes (2004) performed a similar study among American Hispanic students and found strong differences between academic majors. Whereas accounting students are more analytical and decisive in their conclusions, business students tend to focus on the relationships involving people. Their study also confirmed that women are more likely to recognize the nuances of ethical issues and that they show stronger responses concerning unfairness, injustice and moral wrongness. Laczniak and Inderrieden (1987) and Barnett, Brown and Bass (1994) on the other hand found no effect of academic majors on student's ethical perceptions. Cohen, Pant and Sharp (2001) compared ethical awareness, ethical orientation and the intention to perform questionable acts between first year business students, final year business students and professional accountants in Canada. They found few differences between students, suggesting that education has no significant impact on the awareness of ethical issues. However, professional accountants did view some actions as significantly less ethical than students. In contrast, Okleshen and Hoyt (1996) had found earlier that, although differences in ethical perceptions of USA versus New Zealand students existed, there were no differences among students who have experience in an ethics course. This suggests that education does produce better understanding and agreement in ethical values.

The recent acceptance of fair value accounting and the ensuing necessity of management expertise to establish a "fair value" emphasizes the importance of ethical conduct. As the introduction of new rules usually opens up new ways to creative accounting, the management ethics is challenged once more. Opponents of fair value accounting often cite scandals such as Enron[1] to justify their aversion for this new valuation method, whereas the actual reason these scandals take place can be found in a lack of ethical behavior by management and/or auditors. Boosting ethical awareness is one way to improve acceptance of fair value. Another is to establish appropriate estimation methods to minimize estimation bias.

[1] In the Enron case, management distorts the fair value of energy contracts in order to maximize their annual bonuses.

As the students of today will be the managers of tomorrow, we believe our propositions to be valuable to different external parties. Accounting educators may benefit from our results by adapting, if necessary, their ethics curriculum, or obtain confirmation about the adequacy of their programs. Regulators may gain additional insight in the causes of unethical behavior and take appropriate corrective measures. Investors could ask for some preliminary ethical codes of conduct before granting their approval to some projects or appointments. And hiring staff may face a reduction of the agency problem when appointing new employees.

The remainder of this paper is organized as follows. First, a theoretical background which supports the empirical analysis will be formulated on the basis of the literature. Second, the research method will be discussed, followed by a discussion of the results. Finally, the conclusions and their inherent limitations are discussed as well as how this study will be extended in future research.

Theoretical Background

According to the 4th European Directive financial statements should always provide a 'true and fair' view of the company. The meaning of 'true and fair' is not further specified within the directive, but member states are given the opportunity to impose their own accounting rules and principles that should guide accountants and auditors towards financial statements that are 'true and fair' (Bromwich and Hopwood, 1983). However, if the accountant finds that, in some exceptional cases, the financial statements that are prepared according to these accounting rules and principles do not present a 'true and fair' view of the company, it is possible to override these rules (Alexander, 1993). On the one hand, the 'true and fair' concept incorporates flexibility or freedom of interpretation and acknowledges cultural differences between member states, but on the other hand it involves the possibility of manipulation (Zeff, Buijink and Camfferman, 1999). Obviously, the 4th European Directive includes some restrictions to avoid that companies would abuse the 'true and fair' override in order to justify bad forms of creative accounting (Niessen, 1990). Only in exceptional cases, which should be clearly documented, can accounting rules and principles be ignored (Ordelheide, 1993).

Nevertheless, an accountant can also be creative without ignoring accounting rules. Despite any possible restrictions, there are and probably always will be accountants who succeed in applying accounting rules and principles in a way that is clearly not in line with what was intended by the rule, but without violating the law. In many cases however, the line between creativity and fraud is very thin (Griffiths, 1988). Regardless of any ethical judgment of right or wrong, the definitions of creative accounting clearly imply that creative accounting is always a distortion of reality. Things are not reported as they are, but as how the reporter wants them to be perceived. Creative accounting as such is not illegal as long as the applied accounting techniques are not, but it can be an instrument of deception. (Jameson, 1988) The problem is that the users of financial statements often lack the expertise to look through the accounting techniques and to see the facts rather than the figures. (Griffiths, 1988 and Jameson, 1988). In the long run, creative accounting may threaten the integrity of financial reporting. (Samuels et al., 1989).

Then why do accountants continue to be creative ? One might argue that creative accounting is sometimes necessary to tackle problems of relevance of historical cost information. (Griffiths, 1988 and Jameson, 1988). The present or future value of a company is not merely the result of past performance. Recent developments in accounting regulation seem to acknowledge this problem, with a trend towards fair value accounting. Another reason for creative accounting may be an attempt to avoid unnecessary or unwanted market reactions. Income smoothing techniques may be used to avoid risk and uncertainty. Some even argue that in the long run creative accounting is limited to income smoothing because techniques tend to rebound fairly quickly. (Jameson, 1988) However, this is not a generally accepted theory and there are clearly some other possibilities for creative accounting. Results may be kept under control for tax reasons or to avoid fierce wage negotiations. (Naser, 1993) On the other hand results may be improved to obtain external financing or to cover up bad management. (Argenti,

1976) If the manager's bonus is connected to performance one may try to increase reported profits, which is a clear example of agency theory. (Naser, 1993 and Jameson, 1988) In this way the use of creative accounting could be interpreted as a signal of potential failure. (Argenti, 1976) Another, more specific use of creative accounting is to increase the perceived value of the firm at the time of a possible merger or acquisition. (Walton, 2001 and Griffiths, 1988)

We know that creative accounting is, by definition, legal. We know why certain managers and accountants are tempted to engage in creative accounting. But is creative accounting ethical ? To answer this question, we should first of all look at the matter through the eyes of those who may be harmed by the manipulation of information : the users of financial statements. Griffiths (1988) argues that users should be aware of the existence of creative accounting techniques. Although accountants should prepare financial statements that present a true and fair view of the company, it is also their task to assure the continuity of the firm and if this implies using creative accounting techniques, so be it. This is in strong contrast to the opinion of Naser (1993) for whom 'the extent to which any accounting system is to be considered acceptable, depends on its ability to counter any attempts to adopt creative accounting'. Jameson (1988) refers to the ethical dilemma the accountant faces. Should information be reported that is 100% certain and verifiable or should information be reported that is in the best interest of its users ? The 'true and fair' overriding principles deals with this possible dilemma. If the law fails, the 'true and fair' principle takes over. But it is in this case, in the first place, that ethics should guide the accountant's decision.

Unfortunately, there is no set of specific rules that can distinguish between ethical and unethical behavior at any time. A person considers certain choices as ethical or unethical depending on one's frame of reference. This is based on a collective notion of good versus bad, - which is influenced by society and may differ between cultures – the law, a person's education or a professional code of ethics. Although in general the law may be considered as a guide towards ethical behavior, this does not mean that acting within the strict boundaries of the law as such can always be considered to be ethical. The role of education is not limited to specific ethics courses but also involves the ethical behavior of teachers regarding the profession that is taught. (Loeb, 1994) A professional code of ethics should follow the dynamics of the profession. (Jameson, 1988) The accountant faces responsibility not only towards the users of the financial statements one prepares, but also towards the profession by setting high standards of performance and, as such, towards society. (Loeb, 1978 and Windal & Corley, 1980) All this implies that personal ethics are necessary for an accountant to be able to use the choices that are given in an ethical and appropriate way. Making choices is a part of a person's freedom, but by making choices this freedom is also limited and one should always be prepared to accept the consequences of these choices. The same applies to creative accounting and the judgment of the ethical or unethical nature of the techniques that are used. Creative accounting influences the decision making process and one should be aware that incorrect information can lead to unnecessary lay-offs or unsuccessful investments by small, private investors. (Griffiths, 1988)

Research Method

Based on the previous literature review, a list of questions probing ethical awareness and perception of creative accounting was developed. The questionnaire consists of two parts. To enhance understanding of the statements, both parts were translated in the students' mother tongue, Dutch. In the first part, we use 20 statements formulated by Forsyth (1980)[2] to determine the students' ethical orientation. . In the second part, we present the students with 15 statements concerning the ethical acceptability of creative accounting. In addition, two statements were included to find out whether students hold the manager rather than the accountant responsible for accounting choices. Finally, two statements were added, one concerning the responsibility of the legislator and one on creative accounting as a signal of financial distress. A five-point Likert scale, ranging from totally disagree to totally agree, was used to measure the agreement of students with each statement. The questionnaire was presented to two groups of master students in order to assess their level of ethical awareness. The accounting group previously

[2] More recently, this is also suggested by Barnett, Bass and Brown (1994), Elias (2002) and Radtke (2004).

participated in an accounting ethics class, in which the deontology of the accounting profession is discussed. The non-accounting students do not have a similar course in their curriculum. In order to avoid a non-comprehension bias the concept of creative accounting was meticulously explained to the latter group. Validity threats were minimized as the experiment did not take longer than half an hour, was only conducted once, both groups of participants received exactly the same information and were not allowed to communicate while filling in the questionnaire (Cook and Campbell, 1979). In total 78 usable responses were obtained, 33 from accounting students and 45 from non-accounting students.

Following Forsyth (1980) students were classified according to their ethical orientation as defined by the first part of the questionnaire. Depending on the extent to which they are idealists and/or relativists, students can be considered as situationists (high idealism and high relativism), absolutists (high idealism and low relativism), subjectivists (low idealism and high relativism) or exceptionists (low idealism and low relativism). Idealism refers to one's attitudes towards the consequences of an action and how these consequences affect others. High idealists believe moral actions imply positive consequences and that it is always wrong to harm others. Relativism refers to the extent to which universal moral principles and rules are rejected. High relativists believe that it depends on specific circumstances rather than an absolute moral principle whether an action is moral or not. (Forsyth, 1980)

Our research propositions are derived from related research. We want to test whether the differences between men and women and academic majors that were found for ethical awareness in general can equally be applied to the ethics of creative accounting and whether the differences between moral philosophies that seem to be reflected in different ethical perceptions of earnings management still apply after recent accounting scandals.

Hypothesis 1 : There is a significant difference in the ethical perception of creative accounting between accounting and non-accounting students.

Given results from other research we expect accounting students to have a stronger ethical awareness which makes the use of creative accounting less acceptable to accounting than to non-accounting students. (Fulmer and Cargile, 1987, Cohen, Pant and Sharp, 1998, Landry, Moyes and Cortes, 2004) Although other researchers (Laczniak and Inderrieden, 1987; Barnett, Brown and Bass, 1994) found no significant difference, we expect accounting students to be more aware of the possible impact of creative accounting which in turn may lead to stronger ethical awareness on the subject.

Hypothesis 2 : There is a significant difference in the ethical perception of creative accounting between men and women.

Other research has shown that men and women indeed show different ethical orientations in general. Women tend to be less tolerant towards deontological issues and ethical choices in general. (Cohen, Pant and Sharp, 1998, Landry, Moyes and Cortes, 2004) Therefore we expect to find the same difference for the ethics of creative accounting. .

Hypothesis 3 : There is a significant difference in ethical perception of creative accounting depending on students' ethical orientation.

Elias (2002) found that high idealists judge earnings management more harshly while high relativists judge earnings management more leniently. We also expect to find that differences in ethical orientation are reflected in students' perceptions of the ethics of creative accounting.

The theoretical framework of creative accounting also discusses the issue of responsibility and the negative signal that may be implied by the use of creative accounting. The questionnaire therefore included some statements to test whether students find the accountant rather than the manager or legislator to be responsible for the decision to apply creative accounting techniques. We also included some questions to measure if, according to them, creative accounting always implies a negative signal. These latter questions are treated separately in the analysis.

After completing the questionnaire, each student is given three scores : an idealism score, a relativism score and a creative accounting score. The higher these scores, the higher the student's idealism, relativism and ethical acceptance of creative accounting respectively. Following Forsyth (1980) students are also classified as situationists, absolutists, subjectivists and exceptionists based on their idealism and relativism scores. A student whose score is above the median is considered a high idealist or relativist whereas a student whose score is below the median is considered to be a low idealist or relativist. Because the creative accounting scores are not normally distributed, non-parametric tests are applied to test for significant differences between gender, academic major or moral philosophy.

Discussion of results

Table 1 presents the results of a Mann-Whitney Test for differences between mean scores for accounting versus non-accounting students and men versus women. The implications of these results are threefold. First, we find significant differences in ethical orientation between accounting and non-accounting students, measured by both idealism and relativism, although the difference is stronger for the idealism score than for the relativism score. This is in line with other research and has implications for the remainder of our study. If we want to study the univariate relation between ethical orientation and the attitude towards creative accounting, we should do this separately for accounting and non-accounting students to avoid interferences between ethical orientation and major. Second, we find support for proposition 1. Creative accounting seems to be less acceptable to accounting students than to non-accounting students. Third, however, proposition 2 is rejected by our test results. There is no significant difference between the men and women in our sample, neither in general ethical orientation nor in the ethical perception of creative accounting. This is somewhat striking as it is in strong contrast to results generally found in previous research. There is no bias due to the relative number of men or women in one academic major. There are more women (20) than men (13) in the accounting group and almost an equal number of women (22) and men (23) in the non-accounting group. If we test for differences between men and women within the same academic major, no significant differences in mean scores are found.

< Insert Table 1 >

Because of significant differences in idealism and relativism scores between accounting and non-accounting students, we study each group separately to see whether differences in ethical orientation and ethical perception of creative accounting are related. First, we divide the students in a high idealist and low idealist group based on the comparison of their personal score to the mean score in their major. Second, we do the same for the relativism score. Table 2 presents the results of a Mann-Whitney test for significant differences in creative accounting scores between high/low idealists and high/low relativists.

< Insert Table 2 >

We only find an indication of a difference between high and low idealists for non-accounting students. Because this difference is only significant at the 10% level, we should interpret this result carefully. High idealists find creative accounting less acceptable than low idealists. A possible explanation for the different results for accounting versus non-accounting students may be that the consequences of creative accounting are more clear to accounting students thanks to their education so that they find creative accounting as such less acceptable, regardless of their personal ethical orientation. Also, we found earlier that on average accounting students score higher on the idealism score than non-accounting students so the difference within the accounting group may be less relevant. The differences between high and low relativists are not significant.

Due to the results reported in table 2, we no longer expect to find differences in the creative accounting score depending on moral philosophies : situationists, absolutists, subjectivists and exceptionists. A Kruskall-Wallis Test indeed showed that there are no significant differences. This implies that we find no conclusive evidence to support or reject proposition 3. We only find a suggestion that the level of idealism may be related to the ethical perception of creative accounting for non-accounting students who have no experience with an accounting ethics course in their education.

Finally, we look at the question who should be considered responsible for creative accounting ethics and the extent to which the use of creative accounting is perceived as a signal that the firm faces financial distress. Again, we test for differences between accounting and non-accounting students. Table 3 presents the results.

< Insert Table 3 >

It is striking that non-accounting students, with a major in business management, are more likely to see the manager as the one responsible for creative accounting decisions. This implies that accounting students on the other hand probably place greater responsibility in the hands of the accountant. The difference in opinion is significant at the 1% level. On the other hand, accounting students place higher responsibility in the hands of the legislator, who should avoid the possibility of creative accounting, while non-accounting students have no clear opinion on this matter. Neither accounting nor non-accounting students find that the use of creative accounting techniques is always a signal that the firm faces financial distress. The slight difference in opinion is not significant.

Conclusion and suggestions for further research

The research in this paper is concerned with ethical perceptions of creative accounting among accounting and non-accounting students. We search for differences between majors, gender and ethical orientation. We find that accounting students find creative accounting less acceptable than non-accounting students. A possible explanation for this difference, which is in line with results found by other researchers, is that accounting students through their education are more aware of the possible consequences of creative accounting for financial statement users. The difference does not only apply to students' attitudes towards creative accounting, but also to more general ethical orientations. Within the same major however, ethical orientation is not related to the ethical perception of creative accounting. This is in sharp contrast to earlier research concerning earnings management ethics (Elias, 2002). Our results suggest that accounting ethics courses, in which reference is made to recent accounting scandals, may have an impact on how students perceive the ethical acceptability of creative accounting. Another interesting result is that we find no differences in opinion between men and women. While other researchers in general do find that men and women tend to judge ethical questions differently, we cannot support this finding. Further, we find that both accounting and non-accounting students tend to hold themselves responsible for creative accounting decisions in professional life although accounting students put more emphasis on the role of the legislator in limiting the possibilities for creative accounting. Finally, students do not agree that the use of creative accounting should always be interpreted as a signal that the firm is in financial distress.

Although validity threats were minimized, the results could suffer from mono-operation bias and lack of triangulation. A second experiment where students receive a case and participate in a following discussion would be one way to enhance the validity of the results. Another would be to expose business students in another school or another year to the same questions. An entirely different approach could be to compare the results of a students' sample with an actual management sample, or ideally to have a longitudinal framework and ask the students of today the same questions ten years from now. "Tradeoffs are always inevitable and it is unrealistic to expect that a single piece of research could effectively answer all validity issues surrounding even the simplest causal relationship.” (Cook and Campbell, 1979)

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Table 1 : Mean scores for accounting versus non-accounting students and men versus women – significant differences (Mann-Whitney Test)

	Group (n=number of respondents)			
Score	Accounting (n=33)	Non-accounting (n=45)	Men (n=36)	Women (n=42)
Idealism score (min.=10 – max.=50)	36.45***	32.71***	34.78	33.88
Relativism score (min.=10 – max.=50)	33.00*	34.60*	33.50	34.29
Creative accounting score (min.=15 – max.=75)	45.24***	51.20***	50.19	47.38

***p<0.01 **p<0.05 *p<0.1

Table 2 : Mean creative accounting scores for high versus low idealists and high versus low relativists – significant differences (Mann-Whitney Test)

Creative accounting score (min.=15 – max.=75)	Idealism score		Relativism score	
Major	High idealist	Low idealist	High relativist	Low relativist
Accounting	44.50	45.94	45.81	44.71
Non-Accounting	49.77*	52.57*	51.45	50.96

***p<0.01 **p<0.05 *p<0.1

Table 3 : Responsibility of creative accounting and creative accounting as a signal of financial distress

	Accounting	Non-accounting
Responsibility manager (min.=2 – max.=10)	5.03***	6.18***
Responsibility legislator (min.=1 – max.=5)	4.09***	3.04***
Signal of financial distress (min.=1 – max.=5)	2.18	1.89

***p<0.01 **p<0.05 *p<0.1