by Sue Chong

The Ethics of Creative Accounting Does It All Add Up?

Creativity, Principles, and Accuracy

One may think accounting is a clear-cut issue, but creative accounting sure is not. On one hand, creative accounting is not exactly illegal, but on the other hand, it is not exactly widely promoted. The debate gets down to the issue of whether it is ethical or not. To a certain extent, creative accounting does not break any laws, but whether this makes it ethical depends on one's point of view. A main component of accounting is financial statements, where the purpose is to present a fair representation of the company's financial standing. Managers and accountants can employ creative accounting to significantly skew their financial statements. However, this does not occur with all creative accounting cases—managers and accountants can very well employ creative accounting to the best use for the firm, legally and financially.

There is not a set definition of creative accounting, so to clarify, creative accounting in this paper is defined as "a process whereby accountants use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business" (Amat, Blake, & Dowds, 1999). In the United States, the Financial Accounting Standards Board (FASB) sets the accounting standards and rules that are known as "generally accepted accounting principles" (GAAP) (Stice & Stice, 2006, p. 13). Although all managers and accountants must follow these principles when completing financial statements, there are perfectly legitimate techniques that can be employed when computing certain items. This is where the controversy of creative accounting surfaces. Just how creative can managers and accountants be before their actions are considered unethical?

It is extremely difficult to draw an ethical line on creative accounting when the generally accepted accounting principles often allow multiple accounting methods that a company can choose from when calculating certain items. This is due to the many types of businesses in the economy. With all of the different sizes and natures of transactions, it is extremely difficult for there to be just one accounting method for all companies to use, and therefore, multiple accounting methods exist for companies to choose from. For example, in the case of computing depreciation, managers and accountants have several methods from which they may choose. Some of these are straight-line, declining-balance, and double-declining-balance depreciation. Not only can the managers and accountants select any of the multiple depreciation methods when computing depreciation cost, but they can also pick one method for depreciating one thing, such as buildings, and another method for depreciating another thing, such as equipment (Stice & Stice, 2006, p. 550-553). This depreciation example is just one of the many multiple accounting methods that a company can legally employ. Thus, companies will most likely, if not probably, use the accounting method that will give them their most preferred image.

Another reason why a clear-cut line cannot be drawn on the ethics of creative accounting is that managers and accountants must estimate certain figures in accounting. Not all the numbers are known to the exact decimal place and some numbers are not even known close to the "real" amount, so financial statement preparers must use their best judgment in these cases. Going back to the depreciation example, managers must estimate an asset's residual value and useful life value in order to calculate the depreciation cost. (The residual value and the useful life value must be estimated because management must account for depreciation cost as they are using the asset. Management only discovers the real amounts of these values when they dispose of the asset, but by this time, they cannot depreciate the asset anymore, so this is the reason they must make the estimates.) Thus, managers could essentially manipulate the depreciation amount to the figure that they want. Technically, this is not illegal because they are within their rights to estimate the numbers, but it could fall into an unethical area if the true values are grossly misrepresented.

Another creative accounting technique that managers and accountants can employ is entering artificial transactions into the financial statements. With this technique, financial statement preparers can manipulate figures on the balance sheet and move profits from one period to another. For example, a company can conduct a "sale and leaseback" transaction where they sell an asset to a third party and then arrange to lease that good back for the remainder of the useful life. Thus, the sale price under the agreement can be "pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals" (Amat et al., 1999). This allows the company to legally manipulate their income amount in the financial statements, but whether this is ethical or not is an entirely different story.

There is also a creative accounting technique that can be used by timing when a transaction occurs. Management can time genuine transactions to occur at a period of their choosing. This action is definitely within their rights, and they can choose when they want to act upon it. An example of this method is the timing of a sales transaction. If a company owns a piece of land that is worth $250,000 at historic cost, which is the book value amount on the financial statements, and that piece of land now has a current market value of $950,000, management can choose when they want to sell. They can keep the asset until they want to sell it at a period where they want the company's income to increase. This strategy raises some concerns. On the ethical side, the company has not broken any laws, nor have they overstepped any boundaries, but on the unethical side, in a sense, the company is inflating how well they are doing. So yet again, there is no definitive boundary with the ethics of creative accounting.

● accounting manipulation

Proponents of creative accounting argue that all the examples given are done in an ethical capacity. They claim that the FASB has set the generally accepted accounting principles to give managers and accountants various accounting methods from which they can select. When applying certain methods, the companies are going to choose the ones that make their financial statements better. This is the nature of business—to make the company succeed as well as possible. Creative accounting assists in this endeavor.

On the other hand, opponents of creative accounting see it as "accounting manipulation" (Simon, 1998). The opponents believe that creative accounting is used when managers and accountants want to manipulate the financial statements to show a certain outcome. For instance, when managers want to portray better figures in certain accounts to stockholders, they will employ creative accounting techniques to get their desired results. In these cases, management is most likely not achieving a company's ultimate goal of increasing stock value. In the short run, the company's stock value might rise due to the numbers shown by the creative accounting, but in the long run, the creative accounting hurts the ultimate goal of increasing stock value because the company cannot employ the creative accounting techniques forever. Since the company cannot continually deceive stockholders with the figures derived by creative accounting, the reality of the situation must eventually be divulged. When this occurs, this hurts the value of the stock not only at the time, but also in the long run if the company does not go out of business.

The recent accounting scandals of Enron, WorldCom, Tyco, Adelphia, and the like illustrate when creative accounting unquestionably becomes unethical and illegal. In these cases, creative accounting was taken to the extreme. "…The generation of auditors, accountants, and managers present in these companies at the time of their collapses did not respond correctly or quickly enough when confronted with ethical dilemmas…" (Jennings, 2004). In the case of Enron, management employed "aggressive accounting" where there was a total of almost $1 billion in accounting "errors" by the time the company collapsed. Opponents of creative accounting use this case as an example of why creative accounting should not be employed. However, on the other hand, proponents argue that Enron is an extreme case and a case where the consequences are not what creative accounting is intended for. All can see that management was obviously acting unethically in Enron's case, and creative accounting was unfortunately utilized as a way to achieve their means.

Yet with all the controversy surrounding creative accounting, creative accounting has not been abolished and in all probability will not be. With the various accounting options and techniques available to financial statement preparers, creative accounting will always exist. It is doubtful and extremely unlikely that these options will be taken away so creative accounting must be endured whether it is used in an ethical way or not. Ultimately, creative accounting should be used if, and only if, it is within the ramifications of the law and it achieves the company's ultimate goal of increasing stock value. Hence, when using creative accounting, management cannot just benefit the company in the short run. The creative accounting must also benefit the company in the long run, which is what ultimately matters.

● Student Bio ●

Hailing from Palm Beach County, Florida, Sue Chong is currently a sophomore student at the University of Southern California, majoring in Accounting. Enrolled in the joint-degree program at the Leventhal School of Accounting, Sue is working on earning both her bachelor's and master's degrees in four years. Sue is planning on working in the public accounting industry after she graduates with the eventual goal of becoming the chief financial officer of a Fortune 500 company.

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