

## CREATIVE ACCOUNTING, MEASUREMENT AND BEHAVIOR

Alina Beatrice Vladu<sup>1</sup>  
Dan Dacian Cuzdriorean<sup>2</sup>

*ABSTRACT: The purpose of this research is to discuss creative accounting limitation through ethical developments, focusing on features as: measurement and behavior. In this respect we turn to an original search in the literature that comprise together estimation segment in accounting and theoretical developments from behavioral accounting, all with the scope of creating awareness regarding ethics role. After assessing the areas approached, our goal was further to discuss a possible development of a theoretical framework comprising cognitive structures. Important aspects of decision making process were approached and in correlation we discussed the implications that Machiavellian behavior, moral action model and cognitive moral development theory have upon creative accounting measurement and behavior. The originality of the paper consists in the manner we assess the ethics role as the “tone of the top” in the business sector and its implications to measurement and behavior in the area of creative accounting. The findings of our paper indicates that ethics as a solution used for limiting opportunistic behavior in accounting can have an unlimited potential as long term solution.*

*Key words: creative accounting, fairness, measurement, behavior, managerialism*

*JEL Codes: M41, D21, D81, G32*

### Introduction

We are trying to assess creative accounting, not by documenting its practices, since this is a segment intensively discussed in the literature, but through different theoretical developments bases as: model of moral action, Machiavellian behavior and cognitive moral development theory. Known more through their implications in psychology, management and behavioral accounting, we use these particular theoretical developments to explain the foundation of creative accounting, augmenting also the fact that creative accounting cannot be limited by law restrictions as we can find mostly in the literature, but by moral and ethical development. Since its roots are the lack of ethics, the path to limit it is not the punishment or obedience orientation.

The ideas comprised in this paper are related to the reason why companies should continue to use responsibility accounting in spite of frequently cited dysfunctional behavior. Since ambiguity and uncertainty are normal items in course of the business, and the actors involved should find ways to deal with, we turn to beliefs functions whom we consider having the potential to explain the implications for behavioral accounting research and to lead us to logical interpretation of opportunism risk.

The fact that human-decision making is a very complex process is not a novelty for any study. But when dealing with significant ambiguity and uncertainty, inherent characteristics of

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<sup>1</sup>Babes-Bolyai University, Cluj-Napoca, Romania and Pompeu Fabra University, Barcelona, Spain, e-mails: [beatrice.vladu@econ.ubbcluj.ro](mailto:beatrice.vladu@econ.ubbcluj.ro), [beatrice.vladu@upf.edu](mailto:beatrice.vladu@upf.edu)

<sup>2</sup> Babes-Bolyai University, Cluj-Napoca, Romania, e-mail: [dan.cuzdriorean@econ.ubbcluj.ro](mailto:dan.cuzdriorean@econ.ubbcluj.ro)

unethical behavior can interfere, since those items are considered as being part of the problem not part of the solution. In order to sustain our view we have selected from creative accounting area the segment of estimations. We have chosen this segment since most authors that examined the practices of creative accounting found that estimates were the root where the managerial intent chose to manipulate (David, 2004). In the estimations area several items like the following are comprised: conditions for uncertainty (e.g. being the fact that those are not exact amounts but rather outcomes of calculations); the elaboration process is not always easy to deal with (e.g. some accounting estimates are complex and difficult to calculate comparing with others and to make the process even more difficult they are based on available information in a certain date in time); the calculation is based almost entirely on experience, special judgment and always involve some guessing, so those items can be of highly importance when assessing complex estimations. Based on the above, the task to distinguish between “sincere” estimations and “unfair” estimations is not a clear cut.

Bearing in mind the fact that in accounting we can find a vast number of accounting estimates allowed and required by the IFRSs (e.g. historical cost, fair value, net realization value and discounting to present value) and further those possibilities can open the door to manipulation opportunities, the obvious question that we can ask is the following: *IF flexibility in terms of estimations is comprised in financial statements developing process, WHY some companies are using it in order to manipulate their accounting figures?*

Not being against the existence of estimations or flexibility, we like to prove also like Mulford and Comiskey (2002:26), that there is a valid reason for the measurement segment in accounting but that reason does not have to conduct to manipulative behavior but to fair representation of accounting, which is the contrary of the creative accounting outcomes. The fact that estimations are useful and flexibility also, in order to limit creative accounting practices that used them, we consider that the key is not the law and nor their limitation, but rather the determination to conduct an ethical behavior and being aware of the long term consequences induced by such demarche.

Using the path of this research, we try to create awareness regarding the use of opportunistic behavior as having the roots not in the accounting regulations but in the lack of moral development. In this respect we turn to theoretical developments that can form the basis for our argument. In respect to the behavior of creative accounting, in the light of the above explanations, this segment becomes self explanatory for this study.

The purpose of this paper is to argue for the potential of ethical reasoning in limiting opportunistic behavior in accounting, using an original approach that comprise items from psychology, management and behavioral accounting.

### **Previous theoretical developments for sustaining our research question**

The importance of the accounting information is considered above all crucial for decision making process. In this respect the fairness and sincerity in accounting data must be an important matter of concern. Since creative accounting was extensively documented in the literature, various scholars consider that accounting data must be treated with caution since it has the potential to comprise items of unethical conduct (Abernethy, Bouwens and Van Lent, 2012).

We believe that the actual mechanisms dealing with prevention of unfair accounting are not adequate entirely for the economic environment, and the solution to prevent and limit unethical behavior is the ethical reasoning development. We argue that this solution is a long term solution, and even if can comprise complex items of research, measure, discussions and assessing, it worth trying instead of discussing complex measures of detecting creative accounting practices by using

even more complex and most of time misspecification models that can detect only small parts of the problem but not the roots of it.

Based on our view, a solution, if one can be offered, is the last stage proposed by Kohlberg in 1964, as the morality of individual principles of conscience.

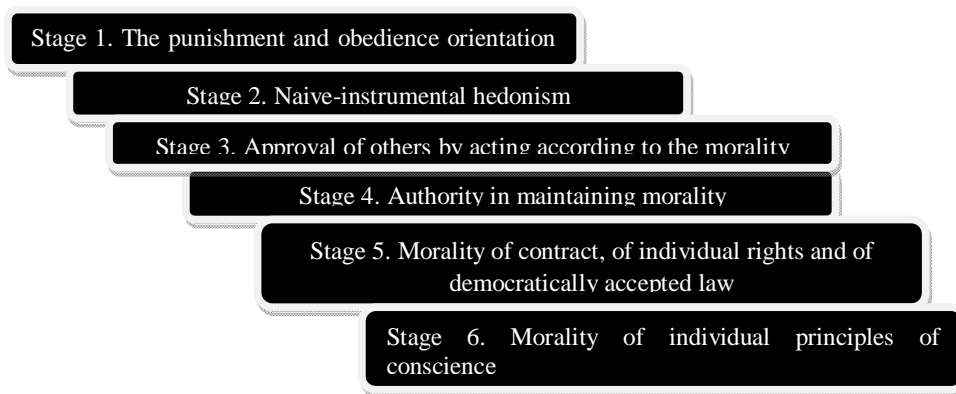
By assessing the below research question we intent to draw attention upon the fact that creative accounting exist primarily because of a lack of ethics not because the existence of the branches in the law. Our main argument is related to the fact that the law always comprised and will comprise items that can be interpreted and manipulated but in this scenario not all companies turn to creative accounting. By trying to limit this behavior using the enforcement of the law or the argument that law is perfectible, can act as a short term solution. Further, for scholars who argue for the “almighty” power of the accounting regulations, we bring into account the complexity of the economic environment that no law can comprise in due time giving it’s rapidly changing features.

By explaining also creative accounting through the market incentives, we also argument the fact that the market incentives works for all the companies in the same way, but some elaborate creative accounting schemes while others do not.

Beginning with cognitive moral development, we accept the fact that the ethical reasoning becomes more complex when additional cognitive structures are acquired as Rest (1986) asserted. We also consider its model as an important basis for the elaboration of our argument. According to Rest (1986) model, the ethical reasoning can be differentiated from all other mental process by three different items that refers to: (1) cognition must be grounded in value and not in tangible fact; (2) the judgment must be based upon issues involving self and others; (3) judgment be framed around an issue of “ought” rather than being based on preference rankings.

In this respect the empirical study conducted by Kohlberg (1969) can be representative also for constructing a valid argument that has the potential to sustain our view. The author researched the cognitive process used by people when making decisions between right and wrong. Previously, the author elaborated a model in six stages related to ethical development, model that can be easily discussed today in spite of the fact that it was developed in 1964. We strongly believe that this model is more accurate than never before if we apply it in current times.

The six phase’s model developed by Kohlberg (1964) comprised the following stages as presented in Figure no. 1 as following:



**Figure no. 1 - Stages comprised in the cognitive process model developed by Kohlberg (1964)**

Source: Elaborated by the authors based on Kohlberg (1964, p. 400)

All discussions comprised in contemporary research in creative accounting area are related to the six stages presented in Kohlberg (1964). In this respect the first stage and the fourth presented by Kohlberg (1964) is offered as a perfect solution by a lot of scholars worldwide for limiting opportunistic behavior. The third stage is also a lot of attention in contemporary research today since the approval of others by acting according to morality and not to focus on self for decision making is also a good root for limiting manipulative behavior (Abernethy, Bouwens and Van Lent, 2012). The fifth stage comprises what today we also refer as “morality of contract”, when what is right must be obeyed but if it is not explicitly written that is wrong, than even if individuals know is wrong; they will turn to it having the excuse that was not written in the law. The last stage developed by Kohlberg (1964) can form the basis for our study as we have asserted above.

In this respect, an important question to be addressed in creative accounting area is NOT how accounting principles and rules allow the use for manipulation, but WHY people tend to manipulate when also they have the path not to do it.

Based on the above we developed the following research question:

- *Ethical development can be a path to limit creative accounting behavior?*

### **Methodology**

Our study is a fundamental study and the research methodology consists in a literature study used in order to examine the literature on creative accounting and ethical developments, with the defined scope of determining whether the first's magnitude can be limited by the latter.

Our research orientation is critical – interpretative and our theoretical framework is based mostly on psychological items. The basic components of our study design are comprising the outcomes that we assessed based on the literature review that previously examined the theoretical developments that we considered useful for our study. So, the objective basis for the reasoning used is based on previous opinions found in the literature.

The literature review in our case was organized thematically and we used *only primary sources*. The information assessed comprise primarily opinions but also facts, in a fewer proportion, elaborated based on the theoretical conceits assessed.

Our study is not an empirical one so the problems associated with the applying of such a method are not found in our study.

### **Findings - Discussions based on critical – interpretative orientation treated in conjunction with creative accounting and ethical reasoning theoretical developments**

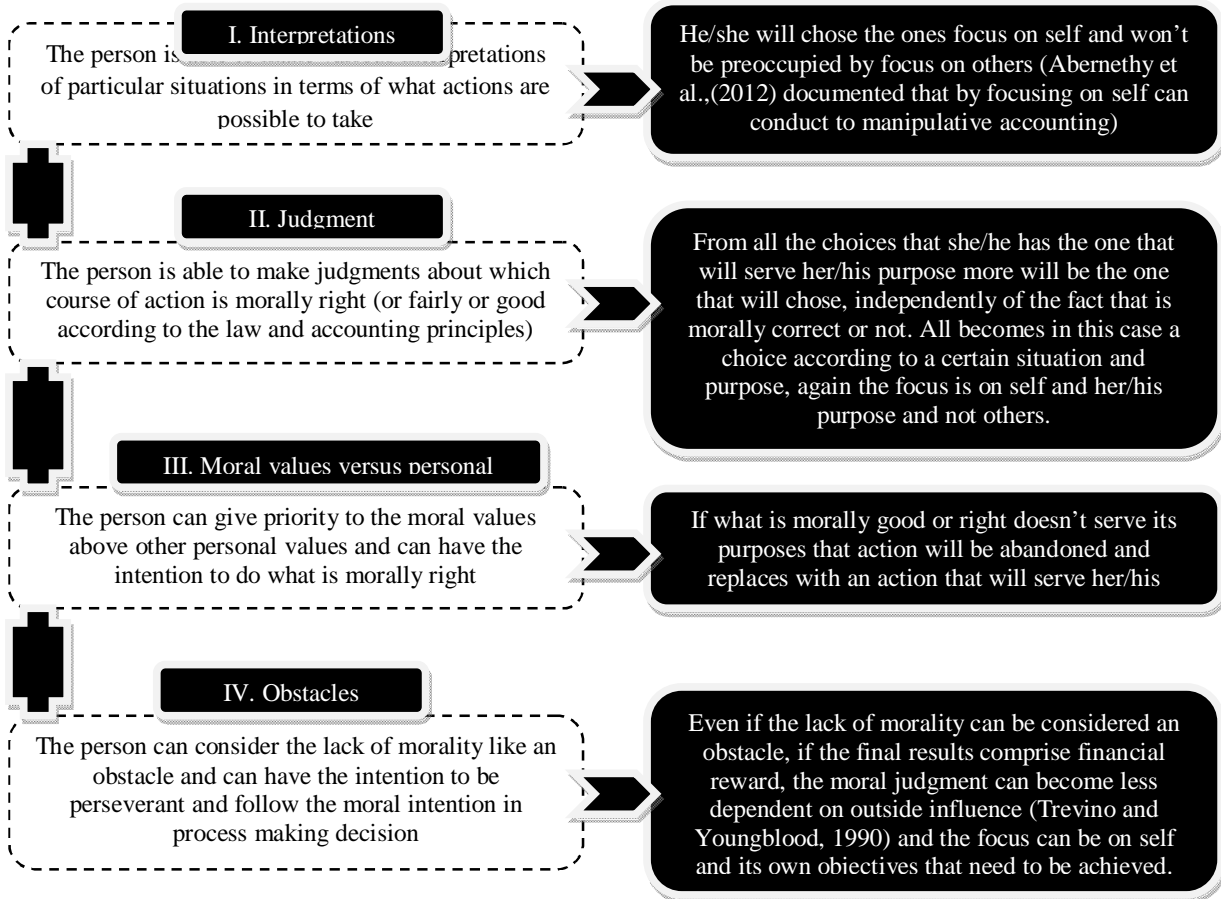
The below framework developed that we intend to discuss, approached the discussions related to the lack of ethical development as the foundation for manipulative behavior in accounting. The first argument that we bring into discussion in order to sustain our view are the studies conducted by Hegarty and Sims in 1978 and 1979, studies that succeeded to document that there is a connection or a established relationship between moral behavior and ethical decision making behavior.

Further, another important opinion can be assessed in connection with our study, is the one developed by Christie and Geis (1970) that stated that manipulative behavior include a lack of conventional morality.

Assessing the creative accounting choices by using the cognitive structures developed by Rest (1979, 1994 and 1999), we propose the following cognitive structure when judging its processes as presented in Figure no. 2. We propose this framework to be used when measuring for the ethical reasoning in connection with opportunistic behavior. By assessing the four stages

proposed (e.g. Interpretations, Judgment, Moral values versus personal values and Obstacle), one can decide upon fairness in accounting. Since our choice was critical-interpretative, we used previous theoretical developments found in the literature in order to argue for our view.

As we asserted above, Figure no. 2 comprise our view and is presented as following:



**Figure no. 2 - Framework comprising cognitive structures used in creative accounting conduct**

Source: Authors` projection

Individuals involved in creative accounting conduct or manipulative accounting, moves from each successive stages their moral judgment but the result is that their moral judgment becomes less and less dependent of outside influences (good moral, what is right according to the society and accounting rules) and becomes more dependent on its inside influences (e.g. Machiavellian behavior, selfish achievements, focus entirely on self).

When dealing with the Machiavellian conduct, which we find as having a great potential to explain creative accounting behavior, individuals focus their ethical judgments upon a personal set of relative ethical guidelines rather upon moral absolutes (Leary et al., 1986). In this case, the wording of the great physicist Albert Einstein is representative (e.g. "Relativity should apply to Physics not to moral").

Opinions when it comes to the Machiavellian behavior are also split, similarly like the acceptance of creative accounting. While some researchers consider this behavior as being immoral (Christie and Geis, 1970), others consider it like the perfect path to achieve career success (Ricks and Fraedrich, 1999). Interestingly, field studies in the areas of medicine and psychiatry indicates that surgeons score lowest on the scale, whereas, psychiatrists score highest. Christie and Geis (1970, p.312) stated that: "High Machs manipulate more, win more, are persuaded less, persuade others more, and otherwise differ significantly from Low Machs in situations in which subjects interact with others".

The proposed framework can be useful in measuring ethical reasoning and further to describe the process most individuals are conducting when making use of ethical decision in accounting making and behavior. If we were to take into account and apply this process into accounting estimations segment than the stages described above can characterize the process of accounting estimates every time is taking place. If we were to assess this area of accounting and according to it to try to explain the basis of creative or manipulative behavior, we can assert that every stage described above can be used by individuals when generating the accounting estimates.

Creative accounting behavior it seems to impact ethical reasoning or to interfere and conduct to unethical behavior that further comprises manipulative items. In this respect, this kind of behavior is close to Machiavellian one, that we found it assessed in management studies. According to McLean and Jones (1992), who studied the Machiavellian behavior, this kind of behavior it seems to be a common stereotype of business behavior. It also impacts the ethical reasoning but further is used as a complex tool that helps explaining differences in ethical reasoning. For this reason we introduced in our discussion the conceits developed by it.

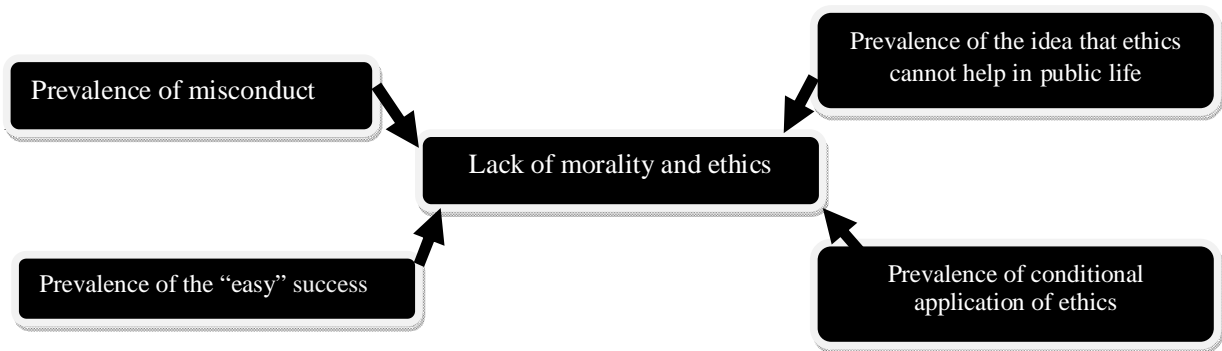
Presented almost exclusively in the business sector, creative accounting behavior, is also similar to Machiavellian behavior since empirical studies that documented the existence of the latter has found support for the argument that business and finance students are more Machiavellian comparing to non-business students (McLean and Jones, 1992).

When this kind of behavior was assessed previously by Ricks and Fraedrich (1999), the results documented that higher scores on the Machiavellian scale obtained conduct to a behavior that is characterized by deceitfulness, lack of sincerity, lack of morality, lack of doing the right things.

Further, we ask ourselves regarding the reasons that form the basis for the actors' decisions involved in creative accounting conducting, to perform their duties with lack of morality. In this respect is well known in the literature that all is related to business success and the desire to gain more since the ethical misconduct was documented intensively.

Due to the fact that for instance, accountants have a public and moral obligation when it comes to elaboration of financial statements, it is expected that this particular category will disagree with the lack of morality and or the lack of ethics. What empirical studies examining creative accounting practices succeeded to document, was not the lack of those practices but the reverse of it how we asserted earlier, conducting to the idea that some accountants agree with the principles of creative accounting and also embrace the principles of Machiavellian behavior since they make use of manipulation of accountants in day to day accounting issues.

Some possible explanation of the lack of ethics or morality in accounting can be the following presented in Figure no. 3, which comprised well known views in the literature:



**Figure no. 3 - Possible roots for lack of ethics and morality conduct**

Source: Authors` projection

We can find misconduct and lack of ethics (e.g. financial scandals previously taking place and extensively documented in the literature) anywhere while fairness is not having the same success. Audit profession for instance, is not dealing with fairness foundation but with the fighting with fraud and lack of ethics. The reason we have so many “watchdogs” in the financial information segment is not because the information provided is fair, but because of the opposite. Also, as the lack of fairness is regarded as a way or path to success, a very easy way without effort, individuals can base on it rather than willing to cross over obstacles in order to achieve success.

Prevalence of the idea that ethics cannot help you in public life, only in private sphere is also approached in the literature (Ricks and Fraedrich, 1999) in this respect individuals tend to limit the power of ethics in business sector since their scope does not have to be subjugated by the means. Also, this item is related based on our understand with the fact that individuals tend to focus less on others and more on self and from here is only one step to manipulative accounting (Abernethy, Bouwens and Van Lent, 2012).

Ethics developments tend to focus in educational areas on discussions related to conditional application according to situation (Abernethy, Bouwens and Van Lent, 2012). In this respect, individuals tend not to absolute the professional life and to judge every situation based on what they have to gain more (Abernethy, Bouwens and Van Lent, 2012). In business life this demarche is equal to getting success, achieving the goals, by all means.

The leitmotif for our study is the choice that individuals must perform when dealing with a sort of financial data. Rezaee (2002:58) discussing about the fraudulent financial reporting assessed that those can be grouped in three categories: conditions, corporate structures and choice. Since the first two are out of our scope of research, we focused on the third one: the choice regarded as an attitude of management and a lack of ethical values. Rezaee (2002) also admits the fact that management must choose between ethical business strategies and illegitimate creative accounting schemes, and choose the latter when their interests are focused on self not others as Abernethy, Bouwens and Van Lent (2012), proved using an empirical demarche later on.

By taking into account the detrimental consequences of financial disasters such as Enron, Parmalat, Worldcom and others, it seems that un-harming creative accounting was able to move nonfiction to fiction and lead to consequences that will be presented long time in the research field.

By being able to explain why the manipulative behavior takes place, what are the incentives for this behavior to manifest and why only some individuals tend to use it when others choose the right path, we can move a step forward into the research of creative accounting area.

In order to contribute to ethical developments, the accounting curriculum in higher education must focus not only on teaching students technical skills (Frank, Ofobike and Gradisher, 2010) such as how to perform accounting estimations, or interpretations of accounting rules and accounting theory but also into explaining the role of ethics in accounting profession and the economic consequences of the lack of ethics. We tend to believe that the role of ethics and morality in accounting profession has been largely ignored from the curriculum and this could have been resulted in the increasing documented of accounting scandals during the past decade.

By including values and ethical behavior into accounting courses and by trying to discuss about the consequences of Machiavellian behavior for the image of accounting profession, we can succeed to prove that business decisions are not just about numbers but also about the actors involved in the process.

### **Conclusions, limitation and scope for future research**

As more attention continues to be placed on the accountants and other actors involved in the accounting elaboration process, more attention is given to the need of better understand the ethical developments and processes of decision making. As the pressure of competition and look for success in our days tend to grew stronger, the lack of ethical issues becomes more and more a reality.

Our goal was to create awareness in this regard. The lack of ethics and business values have as results long term consequences that can also affect the image of this liberal profession (e.g. accounting) and not only. By discussing the ethical developments in the area of creative accounting, we consider the best way to try to assess the multiple facets of decision making process that could also have strong incentives to manipulate and deceive. Using theoretical developments from psychology, management and behavioral accounting, we have proposed a theoretical framework for assessing the decision making processes in accounting area.

By trying to understand the ethical decision making within accounting profession is critical due to the fact that a large percentage of professional reasoning relies upon the ethical beliefs and the behavior of the individuals involved (Frank, Ofobike and Gradisher, 2010). In terms of accounting estimates (the discretionary freedom that managers have over numbers), they are also based entirely on assumptions and judgment. If different assumptions are made, different estimates results and further different financial results would be disclosed in the financial statements, further impacting economic decisions. This is not a problem as long as managers perform their duties based on ethical reasoning.

When creativity combined with Machiavellian behavior interact in this process, ethics and morality lacks from the equation and the code of ethics settled in business sector as “the tone of the top”, becomes without a specific purpose. Contrary, others items contribute to the success of the business when items like the composition of the board, financial skills or remuneration packages come into the scene.

No matter how successful a business can be using not ethical demarches, by comprising items of manipulations the usefulness of financial statements is reduced (Hillier and McCrae, 1998) and serious long term problems can appear (Clikerman, 2003).

The limitation of our study can be due to the sample of literature used and as further developments we intend to focus more on theoretical developments of overall judgment and decision, by assessing other frameworks and formal languages used to assess the ambiguity, uncertainty and lack of ethics as: probability theory, agency theory, possibility theory or epistemic belief functions.



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