



CREATIVE ACCOUNTING: A BRIEF HISTORY AND CONCEPTUAL FRAMEWORK¹



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ABSTRACT

"The accuracy and reliability of the financial statements are crucial for the stakeholders of the firms in order to make appropriate decisions. This fact has become more important in recent years starting from 2001 by the collapse of Enron and its importance has intensified with the recent financial crisis because of the bankruptcy of major financial institutions. Even if there exist strong accounting standards (GAAP and IAS) to guide financial accounting activities, sometimes it becomes impossible to prevent the manipulative behaviour of financial statement preparers, who wants to effect the decisions of the financial statement users in favour of their companies. These manipulative behaviours are often called "creative accounting" and/or "earnings management" "Creative accounting" is the more preferred term in Europe, whereas it more common to use "earnings management" in the USA. The aim of this study is to make a detailed analysis of literature about creative accounting and earnings management, and present a conceptual and historical framework about this topic.

Key Words: Creative Accounting, Earnings Management

YARATICI MUHASEBE: TARİHSEL GELİŞİM VE KAVRAMSAL ÇERÇEVE

ÖZ

Finansal tabloların doğruluğu ve güvenilirliği işletme paydaşlarının uygun kararlar alabilmeleri için oldukça önemlidir. Özellikle 2001 yılında Enron'un ve son finansal krizde büyük finans kurumlarının iflasları ile bu önem daha çok artmıştır. Finansal muhasebe faaliyetlerini yönlendirmek üzere geliştirilmiş güçlü standartlar olsa da finansal tablo hazırlayıcılarının söz konusu tabloları kendi istedikleri yönde etkilemelerine yönelik manipülatif davranışlarını önleyebilmek bazen mümkün olamamaktadır. Bu manipülatif davranışlar genellikle "yaratıcı muhasebe" ve/veya "kar yönetimi" olarak bilinmektedir. "Yaratıcı muhasebe" daha çok Avrupa'da tercih edilen bir terim iken, "kar yönetimi" terimi daha çok Amerika'da tercih edilmektedir. Bu doğrultuda, çalışmanın amacı yaratıcı muhasebe ile ilgili detaylı bir literatür analizi yapmak ve bu konu ile ilgili kavramsal ve tarihsel bir çerçeve çizmektir.

Anahtar Kelimeler: Yaratıcı muhasebe, kar yönetimi, muhasebe manipülasyonu

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1. INTRODUCTION

Financial statements, the outputs of the accounting process, are the mediums by which both the internal and external stakeholders can gain an understanding about the financial performance of a firm. Many of the important decisions given by these stakeholders are based on financial data extracted from the financial statements. Therefore accuracy and reliability of them are crucial for these people in order to make appropriate decisions. This fact has become more important in recent years starting from 2001 by the collapse of Enron and its importance intensified with the recent financial crisis because of the bankruptcy of major financial institutions. To produce transparent, timely and reliable financial statements, accounting process should follow objective and consistent set of rules. Even if there exist strong accounting standards (GAAP and IAS) to guide financial accounting activities, sometimes it becomes impossible to prevent the manipulative behaviour of financial statement preparers, who wants to effect the decisions of the financial statement users in favour of their companies. Complexity and unpredictability of constantly changing environment makes it difficult to consider all possible situations in advance when setting standards. Even if the accounting standards cannot prevent manipulative behaviour in advance, they can curb it afterwards (Wang, 2008) .

One of the early researchers who defined the account manipulation was Copeland (1968). He defined it as some ability to increase or decrease reported net income at will. However as Stolowy and Breton (2000) argues it is a wider concept also including balance sheet transactions. They developed a framework classifying the activities of accounts manipulation in relationship with the two aspects of risk (systematic risk and financial risk) and categorized these activities into two categories as earnings management and creative accounting. Even if they classified creative accounting and earnings management into different categories, many researchers in the literature used them synonymously. “Creative accounting” is the more preferred term in Europe, whereas it more common to use “earnings management” in the USA (Amat and Gowthorpe, 2004). There are also other terms used to represent the accounts manipulation and used synonymously with creative accounting or earnings management, as financial engineering, cosmetic accounting, window dressing, innovative accounting or income smoothing. The aim of this study is to make a detailed analysis of literature about creative accounting and present a conceptual and historical framework about this topic. It is

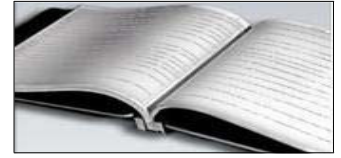


also aimed to explain the factors that give rise to use creative accounting and techniques used for it.

2.DEFINITION AND HISTORICAL BACKGROUND

Although the creative accounting or earnings management concepts have become popular especially for two decades, there has always been a desire to manipulate the numbers among business people. Manipulating numbers to get a favourable impression has a long history. According to Balaciu and Vladu (2010), ambition of making figures more appealing or the opposite, if the case, is as old as 500 years and Luca Paciolo had shaped the practices of creative accounting in his book *De Arithmetica*. Venetian trade men at those times recorded the transactions between themselves by double-entry book keeping with ink and quill-pen in main and subsidiary books. If there arose any inconsistencies the inkwell was occasionally knocked over on these books in order to make entries illegible. This example shows that manipulative behaviour of trade or business people is not a new phenomenon and goes back to centuries ago. However the term “Creative Accounting” was first originated with the movie “The Producers” by Mel Brooks in 1968. In this movie the producers of a play deceive the backers of their play by selling many times over the total value of the enterprise based on the assumption that the play will be unsuccessful, the backers will expect no financial gain, and the producers will have a ill-gotten profit. However the play becomes very successful surprisingly, creating a sensation making the plans of the producers flop (Lee et al., 2013).

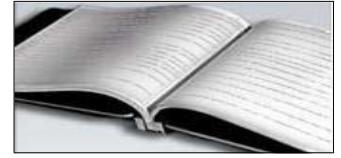
Creative accounting has first become popular as a term among financial and economics journalists in United Kingdom media. Griffiths(1986), city editor of London Evening Standard, was the one who first brought the “creative accounting” topic to the public notice by his seminal book. By this book he made the public become aware of the fact that the flexibility in the accounts could be used for creative accounting (Jones,2011). According to Griffiths creative accounting represents the means by which is achieved a deviation between accounts which are anything other than approximation which have their bases in the transactions and events of the year under review and the original starting point (Belkaoui, 2004). In academic sense, Naser (1993) defined it as the process of transforming financial accounting numbers to the figures desired by the preparers from what they actually are by taking advantage of the existing rules and/or ignoring some or all of them. Shah (1998)



explained it as the active exploitation of gaps or ambiguities in accounting rules by management in order to portray their own preferred picture of financial performance.

Arthur Levitt, chairman of Securities and Exchange Commission in 1998, called attention to creative accounting practices and announced an all-out war on them. He noted that accounting principles were not meant to be a straitjacket and some degree of flexibility was necessary to permit financial reporting to keep pace with business innovations. According to him, the problem arises when companies are using that flexibility to create illusions in their financial reports, illusions that are anything but true and fair reporting (Mulford and Comiskey, 2002). Although Levitt has made some important warnings about the creative accounting and earnings management practices in 1998, these warnings were not enough to prevent big accounting scandals like Enron, World.com, Adelphia and etc. After these scandals Sarbanes-Oxley Act (SOX), which is called by many the most significant securities legislation in US since 1933 and 1934 Securities Acts, was passed in 2002 (Arens et al.,2012). SOX was expected to place a higher standard on the quality of the financial information than in the past, and GAAP would no longer be used as a safe harbor defense against charges of creative accounting practices (McEnroe,2007). SOX specifically targeted fraudulent financial reporting, but at the same time it also impacted other aggressive accounting choices by increasing the cost of engaging in accruals management (Wilson, 2012). Although, SOX was enacted in US, it had a widespread effect on most of the countries' capital markets legislation. For example in Turkey after SOX was passed in US, "The Communique Regarding Independent Auditing in Capital Market"s was adjusted by adding three additional articles about non-audit services of the independent auditors, audit committees and "Responsibility of Preparation and Announcement of Financial Statement and Annual Reports, in November 2002 (Communiqué Serial : X, Number : 19).

There are many different definitions of creative accounting (and also earnings management and other terms related to account manipulation) in the literature. Amat and Gowthorpe (2004), who used earnings management and creative accounting synonymously, has considered creative accounting as involving a transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulation. Sawabe (2005) has emphasized the innovative aspects of creating accounting in manoeuvring accounting



numbers and argued that innovation is an essential part of creative accounting practices involved in innovative accounting practices.

According to (Belkaoui, 2004), creativity in accounting may take different forms depending on the objectives of the financial statement preparers. He grouped them as “big bath accounting” and “creative accounting”, and defined creative accounting as a popular term used in press, to what journalists suspect what accountants do to make financial results look much better than they should. He also mentioned different definitions of creative accounting by different researchers. Steps taken by management to drastically reduce current earnings per share in order to increase future earnings per share is referred as big bath accounting, and in some studies it is defined as one of the creative accounting techniques.

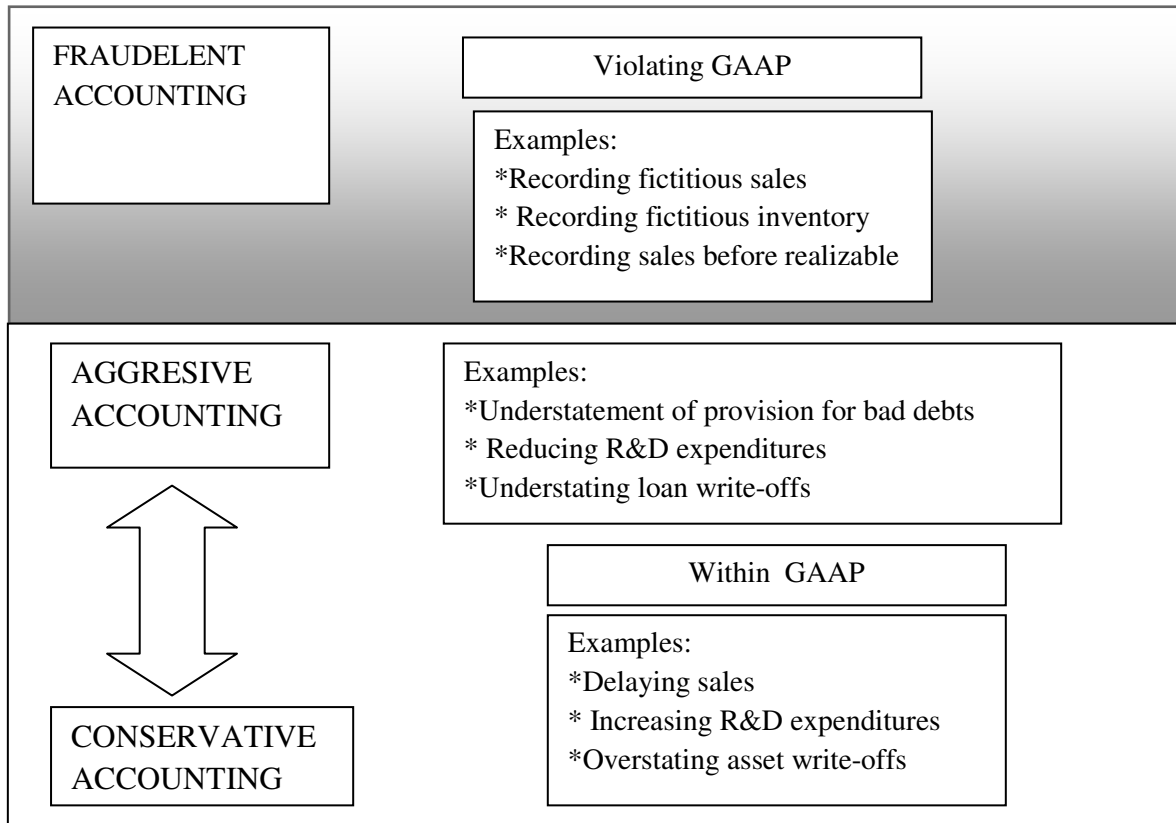
Even if many researchers used creative accounting and earnings management synonymously, there are also studies which evaluated these two concepts separately. One of the most cited definitions of earnings management was made by Healey and Whalen (1999). They defined it as the use of judgment by managers as to alter financial reports in order to either mislead some stakeholders about the underlying economic performance of the firm or to influence contractual outcomes that depend on reported accounting numbers. Nelson et al.(2003) interpreted this definition and concluded that three kinds of earnings management exists: *earnings management that is consistent with GAAP* like structuring leases to allow lessors to use capital lease treatment and recognize gross margin at lease inception; *earnings management that is difficult to distinguish from GAAP* like over- or under-estimating bad debt reserves and *earnings management that is clearly not GAAP* like intentionally misapplying revenue recognition rules.

Jones (2011) conducted a deep literature review about earnings management and as a result classified these studies into different groups. The first group he mentioned consist of early studies carried on 1970’s, which were first of all concerned with establishing the incentives that management have for creative accounting. These studies generally used the term “income



smoothing”(increasing profits in bad years and reducing them in good years) and tried to test and find the evidence for it. The second group of studies hypothesized that there were incentives for managers to meet their own annual forecasts and also of stock market analysts, so he called them the studies about “meeting management or analysts’ forecasts”. Another group of studies examined accounting income changes associated with maintaining and not breaching loan covenants. These studies found that managers attempted to manipulate earnings and the balance sheet so as not to breach their debt covenants. The set of studies that looked at earnings management from the perspective of managers, who manage earnings to be able to receive higher bonuses, generally found evidence consistent with the expectations of managers. In another group, he classified studies, which investigated what happened when a new management took over a company, especially when the old management had been underperforming. They found the evidence of “big bath” approach.

Figure 1: Relationship of Earnings Management with GAAP



Source: Alexandra Fong, “Earnings Management in Corporate Accounting: An Overview”, Cross-Sections, Vol:2, 2006, p.84

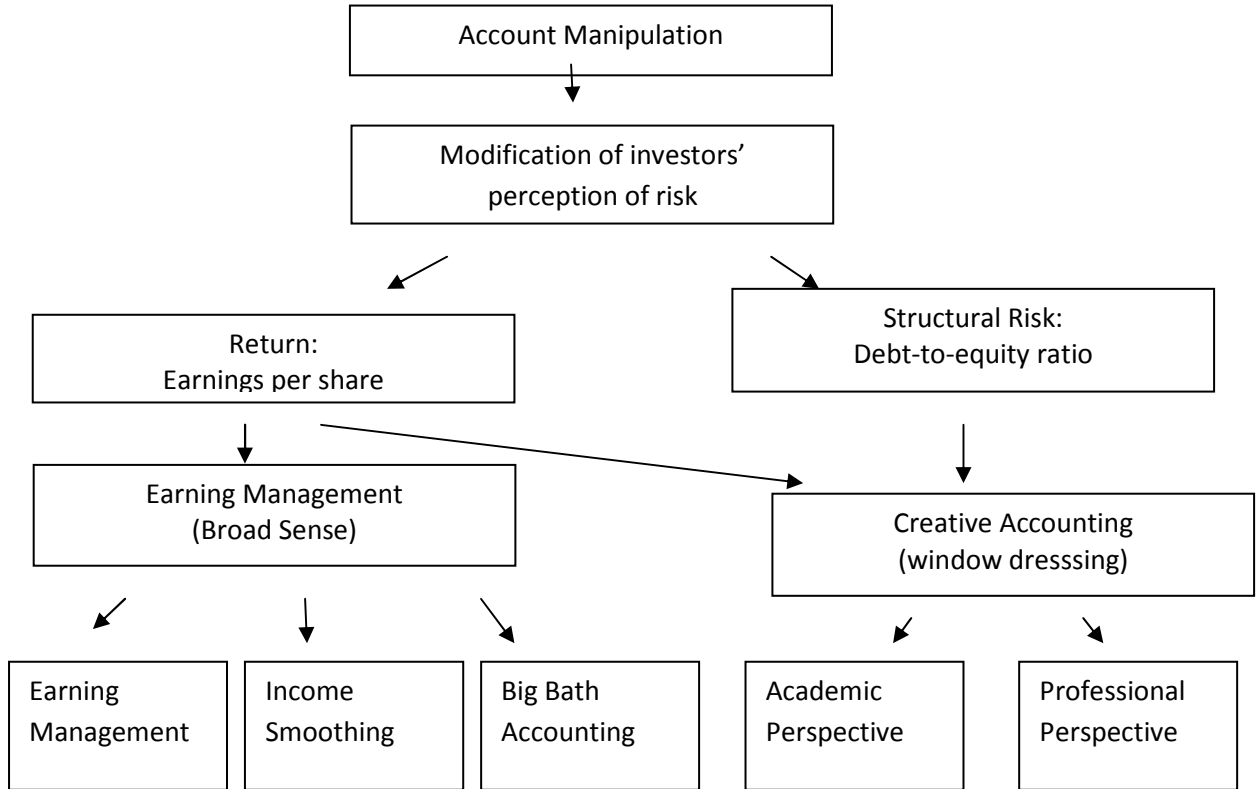


Fong (2006) has also mentioned that earnings management, encompassed a range of behaviours from ‘conservative accounting’ to ‘fraudulent accounting’, and emphasized the importance of definition of earnings management, because of the extremely adverse consequences of “fraudulent accounting” which was an extreme form of earnings management. Mulford and Comiskey (2002) recognised creative accounting as any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, fraudulent financial reporting, and any steps taken toward earnings management or income smoothing. They asserted that earnings management and income smoothing are subsets of creating accounting and defined earnings management as active manipulation of earnings toward a management, a forecast made by analysts, or an amount that was consistent with a smoother, more sustainable earnings stream. Income smoothed was admitted by them as a form of earnings management designed to remove peaks and valleys from a normal earnings series.

Yaping (2005) argued that there are inconsistencies in the definitions of earnings management in the literature and distinguished earnings management from earnings manipulation, earnings fraud, and creative accounting. In this paper Yaping (2005) defined “earnings manipulation” as deliberate steps taken by management to bring reported earnings to a desired level; if this manipulation is exercised through the discretion accorded by accounting standards and corporate laws, and/or structuring activities in such a way that expected firm value is not affected negatively, she called it “earnings management”. She argued that “earnings fraud” is the earnings manipulation by violating accounting standards and corporate laws, and/or structuring activities in such a way that reduces expected firm value. In the same paper “creative accounting” was defined as the earnings manipulation practices that do not violate accounting standards or corporate laws because of the lack of relevant standards or laws, for example, when firms engage in business innovations.



Figure 2: Classification of Accounts Manipulation



Source: Hervé Stolowy and Gaétan Breton, “A Framework for the Classification of Accounts Manipulations”, HEC Accounting & Management Control Working Paper No. 708/2000, 2000, Volume 3, No:1, p.4

Stolowy and Breton (2000), developed a framework for account manipulation and assumed that these manipulative activities are aimed at modification of investors’ perception of the risk. So, they argued that account manipulation tries to modify the earnings per share and/or debt-to-equity ratios. Figure 2 (on page 7), depicts the general framework that they have developed for account manipulation. In this framework they grouped income smoothing and big bath accounting under the broad concept of earnings management, and treated creative accounting as window dressing.

After reviewing the narrow and wide definitions of creative accounting Jones (2011) ended up with the definition of creative accounting as follows: “Using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give privacy to the interest of the preparers not the users”. As he mentions in his book, in United States, where it is referred as earnings management, creative accounting is



defined in a wider perspective including fraud, whereas in United Kingdom and Europe it is seen as using the flexibility within the regulatory system but excluding fraud (Jones, 2011).

3.MOTIVATIONS FOR CREATIVE ACCOUNTING AND EARNINGS MANAGEMENT

There are many factors regarded as the reasons of applying creative accounting or earning management techniques. One of the most cited incentive in the literature is the expected increase in the stock prices. It is not surprising since the ultimate goal of the firm should be maximizing the firm value. A company's ability to generate a sustainable and likely growing stream of earnings that provides cash flow is likely to have a positive effect on stock price, because investors seek out and ultimately pay higher prices for corporate earning power. To have an effect on the share price, that cash flow either must be provided currently, or there must be an expectation among investors that it will be provided in future years. Thus, using creative accounting or earnings management techniques may be one way to communicate to investors that a firm has higher earning power, helping to foster a higher stock price (Mulford and Comiskey, 2002). Creative accounting may help maintain or boost the share price both by reducing the apparent levels of borrowing, so making the company appear subject to less risk, and by creating the appearance of a good profit trend (Amat and Gowthorpe, 2004)

To increase the stock price it is not the only motivational factor of creative accounting. At the same time managers can use earnings management to smooth earnings in order to present future debt holders with low variance income streams and lower the required return of the debt holders and thereby the firm's long-term cost of capital (Stolowy and Breton, 2000). Moreover instable profits may make a company vulnerable to stock price fluctuations and even a hostile takeover. Company with instable profits will be perceived as riskier and less well managed compared to a company with steady profits (Jones, 2011).

Earnings-based compensation can also make managers apply earning management techniques. Managers can engage in earnings management to just meet an earnings benchmark to increase job security or bonuses (Gunny, 2010).



In some circumstances where it is not in a company's interests to appear to be exceptionally profitable, earnings management might be employed to manage earnings down. However, the effectiveness of this earnings management will hinge on the recognition or acceptance of the reduced profit level as being legitimate by the key players (Mulford and Comiskey, 2002). For example, oil companies have used income decreasing accounting policies during the Gulf War to avoid the political consequences of a higher profit coming from increased retail prices (Han and Wang, 1998).

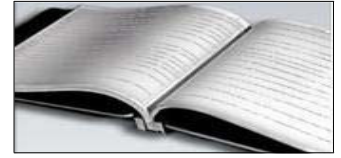
4. TECHNIQUES OF CREATIVE ACCOUNTING AND/OR EARNINGS MANAGEMENT

In this section techniques used for creative accounting and/or earnings management will be explained based on different studies in the literature.

- ***Recognizing Premature or Fictitious Revenue:*** As (Mulford and Comiskey, 2002) asserts, creative accounting practices often begin with revenue recognition, because of its direct impact on earnings. They defined premature revenue recognition as recognition of revenue for a legitimate sale in a period prior to that called for by generally accepted accounting principles. On the contrary, fictitious revenue recognition is the recording of revenue for a nonexistent sale.
- ***“Big Bath” Accounting:*** According to Jones (2011), big bath is a managerial strategy to get rid of all the bad news in one go. In this technique managers write off as many costs as possible in the current period, so that the future performance looks better. It is widely used in acquisition accounting and in takeovers.
- ***Using Cookie Jar Reserves:*** It refers to over-provisioning for accrued expenses when revenues are high, so that profits can be brought down to a level that is safe to maintain in the future. It also includes failure to provide all the accrued expenses to show larger profits during tougher times when needed (Shah and Butt, 2011). As Levitt (1998) states this technique includes making unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs, so that they stash accruals in cookie jars during the good times and reach into them when needed in the bad times.



- ***Aggressive Capitalization and Extended Amortization Policies:*** One alternative way for companies to reduce expenses is aggressively capitalizing expenditures that should have been expensed. Although determination of the portion of an expenditure to capitalize is straightforward in many cases, items as direct-response advertising and software development costs require judgement in determining whether capitalization is appropriate or not. To lengthen amortization periods for costs that have been capitalized previously is also used to reduce expenses and boost earnings (Mulford and Comiskey, 2002).
- ***Manipulating Inventory:*** Firms can engage into inventory manipulation by either manipulating the quantity of the inventory or by valuing it. In years when profits need to be increased the quantity can be manipulated by doing a particularly rigorous stock-take. Provisions for absolute and slow-moving inventory and changing the actual method of inventory valuation are the practices of manipulating inventory values (Jones, 2011).
- ***Abuse of Materiality Concept:*** It includes misusing the concept of materiality by intentionally recording errors within a defined percentage ceiling. Firms indulging in this practice try to find an excuse for it by arguing that the effect on the net income is too small to matter (Levitt, 1998).
- ***Being Generous with Bad Debts:*** Companies, which are based on credit sales, make provisions for bad and doubtful debts based upon their judgement. Thus, when they want to increase their profits, managers can forecast that there will be a very low level of non-payment (Jones, 2011).
- ***Getting Creative with the Income Statement:*** It includes the practice of communicating a different level of earning power using the format of the income statement rather than through the manner in which transactions are recorded. For example, companies may report a nonrecurring gain as “other revenue,” a recurring revenue caption, or a recurring expense might be labeled as nonrecurring. This will result in higher apparent levels of recurring earnings without altering total net income (Mulford and Comiskey, 2002).



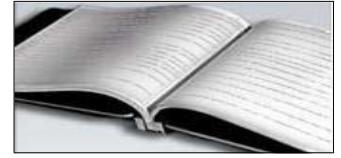
- ***Problems with Cash-flow Reporting:*** Another way for companies to communicate a higher earning power is reporting higher and more sustainable cash flow. A company's apparent earning power will be greater with the potential recurring quality of operating cash flow. Therefore, a firm can classify an operating expenditure as an investing or financing item, or investing or financing inflow might be classified as an operating item. Even if these steps will not alter the total change in cash, they will increase the cash flow from operations (Mulford and Comiskey, 2002).

5.REVIEW OF EMPIRICAL STUDIES

As mentioned before different authors used different terms for accounts manipulation. We can see these terminological differences also in the empirical studies. Empirical studies which focused on creative accounting have gone over the effect on the earnings to consider also the effects on the financial leverage. They have made in depth analysis of accounts in order to find the doubtful applications of accounting procedures and standards, and as a result the results of these studies suggested that accounts were effectively manipulated to produce a better image of the firm and convince investors to accept a lower rate of return (Stolowy and Breton, 2000).

Breton and Taffler (1995) used a case study based experimental approach to investigate the impact of window dressing on stockbroker analyst evaluation of a company's annual accounting numbers. They developed a case study from the financial statements of two companies with all identifying information removed. One set of accounts was left unchanged, to serve as a control, and the other was manipulated to contain different combinations of the window dressing practices. The case studies were administered to 63 experienced stockbroking analysts under controlled conditions who, after completing and handing in the main task, filled in a short personal questionnaire. As a result, window dressing correction rates in the study were very low. Thus, they concluded that stockbroking analysts did not adjust their financial analysis directly to take into account creative accounting in financial statements.

Shah (1998) tried to explore the environment of creative accounting in the UK, focusing on the motivations and constraints on such practices, by examining the accounting practices of



two UK companies which issued creative financing instruments. He found that creative accounting in the United Kingdom is influenced by two key motivators: stakeholder contracts and performance indicators. Moreover, analysis showed that management took advantage of gaps in accounting standards to present a biased picture of financial performance.

Although majority of the studies concerning creative accounting and earnings management have focused on large and developed countries like USA and UK, there are also studies which were carried on other countries. For example, in Spain Amat et al.(2003) assessed the impact of creative accounting practices on reported earnings of Spanish listed companies. It was revealed in this study that the aggregate impact of creating accounting practices on earnings amounted 20% of total reported earnings. Baralexis (2004) has investigated why, how, to what extent, and in what direction creative accounting was practised in Greece. The results of the study indicated that creative accounting was practised in Greece frequently, and to a considerable extent mainly with the blessing of the law. The findings also suggested that large firms augmented profits for external financing, while small firms understated profits to reduce income taxes.

In Turkey, Kucukkocaoglu and Kucuksozen (2005) aimed to detect manipulated financial statements of firms listed in Istanbul Stock Exchange by using logistic regression model. Their findings demonstrated that return on assets and ratio of funding costs to operating expenses were the variables that can be used to detect the manipulation of financial statements.

Bayirli (2006), has focused on the scope, incentive factors, limits, practice methods and results of creative accounting in Turkey. In order to determine the creative accounting practices of Turkish firms he used accruals method and used modified Jones model by adding country specific variables. One of the important findings of his study was that the motivation of creative accounting practices by using accruals diminished as the size of the firm increased. He also revealed that as the degree of financial leverage increased the motivation of using creative accounting practices also increased.



Omurgonulsen and Omurgonulsen (2009) have examined the creative accounting practices in Imarbank, which is one of the recent banking scandals in Turkey, using case study methodology. They have concluded that significant reasons of creative accounting practices in that case were deficiencies in the legal frameworks for banking and accounting, inadequacies in the autonomy of governmental regulation and supervision bodies, practical difficulties in enforcing legal and ethical rules due to the slow functioning of the judicial system. In addition, personal greed of both owners and top management of Imarbank and its customers were accepted as stimulating factors of creative accounting.

Recently, Osazevaru (2012) investigated the effect of creative accounting on firm value in Nigeria, and the findings of the study revealed that it can positively affect firm's value. Another recent study, which also focused on Nigeria, is by Idris et al.(2012). Using survey method, they investigated the practice of creative accounting, its nature, techniques, and prevention. The findings of the study showed that the current GAAP in Nigeria created a gap that can permit the practice of creative accounting, and also revealed that the new International Financial Reporting Standard will go a long way to reduce the practice, since it covers more areas than the former practice. They concluded that one of the best ways to prevent the practice of creative accounting is to enforce both preventive as well as strong enough punitive measures on those that engage in the practice.

The studies mentioned above were the ones which preferred to use the concept of creative accounting. The other research stream focused on earnings management and income smoothing. Most of the prior studies on EM have concentrated on how accounts were manipulated through accruals. They have focused on specific accruals as being more prone to be used for earnings management purposes. The most cited paper in this research stream is the Jones (1991) model, which he took all the accruals, except the ones related to taxes, as more likely to express earnings management. Recent models following Jones refined his model and some studies have taken the difference in cash flow movements as being a good measure of the real evolution of the firm. This measure can be the best one in the absence of natural income manipulation (Stolowy and Breton, 2000). These studies have typically examined broad measures of earnings management especially the measures based on total accruals and samples of firms in which motivations to manage earnings were expected to be strong. The



findings of them showed that firms managed earnings to window-dress financial statements prior to public securities' offerings, to increase corporate managers' compensation and job security, to avoid violating lending contracts, or to reduce regulatory costs or to increase regulatory benefits (Healy and Wahlen, 1999).

Caramanis and Lennox (2007) tried to find out the impact of audit effort on earnings management by measuring the audit effort using a unique large database of hours worked by Greek audit firms. In the study where earnings management was measured by abnormal accruals and the incidence of small profits, they found that companies are more likely to report income-increasing abnormal accruals than income-decreasing abnormal accruals, when audit hours were lower.

Mcenroe (2007) surveyed CFOs of the Fortune 500 firms and audit partners for the 33 largest audit firms to investigate as to whether they perceived that SOX significantly reduced various earnings management practices in audited financial statements in general. He found that CFOs and audit partners of firms affected by SOX did not perceive, for the most part, that the legislation had significantly reduced earnings management in audited financial statements. On the other they felt that it has been more effective in reducing clear GAAP violations than earnings management within GAAP. Recently, Wilson (2012) also investigated the impact of Sarbanes-Oxley (SOX) on managers' earnings management choices. By using a probit regression that related a firm's probability of meeting an earnings benchmark with the firm's abnormal accruals, abnormal production costs, and abnormal discretionary expenses in the pre-SOX and post-SOX periods, he indicated that managers increased their use of production cost manipulation in the post-SOX period. The result of his study also indicated that SOX had no significant effect on the use of accrual manipulations or discretionary expense manipulations to meet earnings benchmarks.

Gunny (2010) has examined the future operating performance of firms that use earnings management to just meet earnings benchmarks. After controlling for size, performance, growth opportunities, and industry, she found that earnings management practices were positively associated with firms just meeting earnings benchmarks. In addition, the findings of the study revealed that firms engaging in earnings management to just meet earnings



benchmarks had relatively better subsequent performance than firms that did not engage in earnings management and missed or just met the benchmarks. As a result she concluded that engaging in earnings management was not opportunistic, but consistent with the firm attaining current-period benefits.

In a study which focused on Turkish firms Atik (2009) detected income-smoothing practices of Turkish listed companies by using Moses' smoothing behavior index. The findings revealed that nearly 60% of the sample firms were smoothers and 40% of the sample firms were nonsmothers. At the same time she found a significant association between income-smoothing behavior and total debt to total assets ratio, prechange earnings deviation and directional impact of the accounting change variables.

In another study focused on Turkish firms, Uyar and Kucukkaplan(2011) analysed the effect of fraud and errors in financial statements on the stock price of the public firms. As a result they found that the financial statement fraud and errors published by Capital Markets Board had no effect on the stock prices of listed firms.

Karacaer and Ozek (2010) investigated the relationship between the earnings management and auditor size using 645 observations from the companies listed in the Istanbul Stock Exchange National All Index between 2005-2008. They found a negative and statistically significant relationship between the discretionary accruals and auditor size which suggests that the big four auditors constrained the earnings management in Turkey. A research by Tsiouridou and Spathis (2012) examined the relationship between earnings management and auditor reporting for firms listed on the Athens Stock Exchange (ASE) for the post-IFRS period 2005–2009. According to the findings of the study, auditors, either Big 4 or non-Big 4, had weak incentives to prevent earnings management, and the audit opinion qualification was not issued in response to management's opportunistic behaviour.

Ergin (2011), analysed the income smoothing behaviour of firms listed on the Istanbul Stock Exchange, for the five-year period 2006-2010. He used logit analysis and found that very large sized firms were less likely to have smoothing behaviour than small sized firms, and



firms in service industry were less likely to have smoothing behaviour than firms in financial industry.

The ethical side of the creative accounting and earnings management practices were also the subject of interest in the literature. For example Amat et al.(1999) have reported on surveys of auditors' perceptions of creative accounting in the UK, Spain and New Zealand to investigate the ethical issues raised by creative accounting. When they compared the findings of two studies conducted in UK and Spain surveying auditors' views on creative accounting, they found that substantial minority of auditors in each country taking a tolerant view of creative accounting. In Spain there seemed to be more optimism on prospects for resolving the problem. In another study, Blake et al.(2000) discussed the ethics of creative accounting and their study revealed that creative accounting has been seen as primarily as an “Anglo American” problem, has caused growing concern in Spain, and was widely perceived as ethically undesirable.

6.CONCLUSION

In this study concept of creative accounting and earnings management were discussed in detail together with the historical background and empirical evidence of the previous literature. Some practitioners and academicians see creative accounting as an illegal act, however there is a group of people who think that it includes taking advantage of the flexibility in accounting standards and accepts it as a legal act. Even if we see it as legal or not, the role it played in big accounting scandals including the recent financial crisis is an undeniable fact. Regarding the creative accounting game only as a game played with numbers on paper would probably facilitate such scandals with a widespread effect on many countries.

Some researchers wonder why accounts should not be manipulated when compared with all other activities in the world, like marketing, and ask “Why would they be easy to mislead or, at least, to influence when they buy products and impossible to influence when they buy share?” (Stolowy and Breton, 2000). When you buy a product or service of company and become disappointed with it, you have a choice not to purchase it again. However, when you buy a stock of a company you become one of the shareholders. If your stocks loose considerable amount of value, this would probably affect you more than a product with an unexpected poor quality. As Levitt (1998) mentions on his famous speech, “Numbers in the



abstract are just that -- numbers. But relying on the numbers in a financial report are livelihoods, interests and ultimately, stories: a single mother who works two jobs so she can save enough to give her kids a good education; a father who laboured at the same company for his entire adult life and now just wants to enjoy time with his grandchildren; a young couple who dreams of starting their own business.” Therefore, the effect of creative accounting or earnings management practices, no matter what we call it, on stakeholders as a whole should not be disregarded.

If the creative accounting starts with the loopholes in the accounting standards maybe one of the biggest roles belong to the standard setters in decreasing the possible negative effects of creative accounting. As Wang (2008) states, one of the main strengths of accounting standards is careful definitions and clear explanations of relevant accounting items which can prevent the abuse of accounting definitions that is fundamental to creative accounting. He also argues that International Accounting Standards are continuously improved as new techniques of creative accounting emerge and sees creative accounting as a drive to the creation and improvement of International Accounting Standards. This point of view is not incorrect however it is more important to intensify the careful definition and clear explanation qualities of the standards.

It would be unrealistic to think that it is possible to eliminate creative accounting or earnings management practices at all. However it would be possible to minimize at least the negative effects of them by adopting the accounting standards, giving more importance to ethical considerations and decreasing the flexibility of the managers in deciding among different accounting methods.

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