



Creative Accounting Related Practices Among Corporations Listed in Nairobi Securities Exchange in Kenya

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Abstract

Creative accounting is influenced by a number of management accounting practices. The raison d'être for this study was to assess creative accounting related practices among listed on the Nairobi Securities Exchange (NSE) in Kenya. The study identified four major practices which were dominant in the literature reviewed. Systematic sampling method was applied in selecting the sample for the study. The research design used in this study was a cross sectional survey design which assessed data for the year 2014. Data was acquired through administering questionnaires and interviews to a sample of managers, accountants and internal auditors of companies publicly listed on the NSE. A sample of thirty nine out of a target population of sixty four Companies publicly listed was extracted from the Nairobi Securities Exchange website. Simple descriptive statistics were employed to establish the level of agreement or disagreement by respondents on the influence of the said practices on creative accounting.

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The results indicated the level of agreement by respondents on influence on creative accounting among the companies listed on the NSE for practices such as Managements compensation, contractual obligation, tax management and insider dealings.

Keywords: Creative Accounting; Accounting practices; NSE; Kenya.

1. Introduction

Creative accounting is as old as the accounting profession itself. Creative Accounting continues to be a problem despite the fact that accounting scholars have over the years carried out several researches in order to understand and address it. Creative accounting continues to be practiced by various corporations in the world including in Kenya hence the researcher's interest in its determinants. Much of the studies which relate to practices influencing creative accounting dwell mainly on the positive accounting theories but this paper included practices associated with agency theory and information theory so as to have a wider view of the problem.

Creative accounting is described as modification of accounting figures to what the organizations managers and directors desire by exploiting the loopholes of the existing rules and/or ignoring some of them. Creative accounting involves those practices which are openly displayed such as window dressing and those which are sophisticated such as off-balance sheet financing [1].

1.1. Literature critique

The literature reviewed indicated that quite a lot have been documented on creative accounting. Balaciu and Pop [2] highlighted the various motivations behind practice of creative accounting more so in Bangladesh. Their study was in line with the three hypotheses advanced by positive accounting theory. However their study only provided a theoretical perspective and no measurements were carried out to investigate the factors further, it was a form of literature review. Sen and Inanga [3] singled out the root cause of creative accounting as the conflict of interest between management and the various users of accounting information. Their study however focused more on the effects and not the causes. The methodology used by Sen and Inanga [3] to measure creative accounting range from dichotomous scale to likert scales.

Baralexis [4] confirms that creative accounting is widely practiced in Greece and carried out further studies on the techniques mostly applied to manipulate financial reports. The study covered less of the determinants and the methodology adopted was mostly rankings of various variables. Smith [5] carried out studies on creative accounting which mainly centered on the techniques involved; the researcher used comparative analysis among various auditors to make conclusions. Dechow and his colleagues [6] in a detailed research expanded on the techniques employed in engaging creative accounting as well as how to detect such practices; the researchers employed a time series methodology and the earnings management model to estimate misstatements in the accounting information. Gosh [1] also identified a number of factors that motivates creative accounting; his study employed a literature review mode and no measurements were used to explore the creative accounting motives determined.

Shah and Butt [7] explained some motivations of creative accounting to include: to meet internal targets, meet external expectations, provide income smoothing, window dressing for an IPO or a loan, taxation and change in management. They used discussion based model which applies past references and experiences to link governance with creative accounting. No measurements were made to further investigate link between governance and creative accounting.

Rabin [8] discussed the factors that influence auditor's attitude toward creative accounting. The study looked into whether auditors' attitudes towards creative accounting was related to ethical judgment, auditors evaluation of the quality of financial reporting and their opinions on factors that influence financial statement's preparers to use aggressive accounting techniques. There was no analysis on the practices influencing creative accounting but on determinants of auditor's perceptions on creative accounting. The methodology used to analyze data was linear regression analysis and factor analysis.

Kassem [9] attempts to provide a distinction between fraud and creative accounting also reoffered to as earnings management. Fraud is material false statement whose intent is to deceive and persuade reliance on the false statement by the victim. Earnings management involves using the flexibility within accounting regulatory framework to manage the accounts in order to deliver a predetermined profit or attain a specific objective. The research was literature based hence no measurement of variables was involved.

Effiok and Eton [10] concluded that creative accounting affects a firm's share price and capital market performance as a result of financial statements manipulation. It also affects management decision to acquire new assets or even replace existing ones. The creative accounting may also lead to tax evasion and may also cause investors to lose their hard earned money. The researcher adopted multiple regressions model for this study. Amat and Gowthorpe [11] carried out a literature review on the various ways in which creative accounting can be undertaken and sums up some empirical research on the nature and incidence of creative accounting. The ethical dimension of creative accounting is also discussed, drawing evidence from several empirical studies. Demirtas and Cornaggia [12] carried out multivariate regression analyses which suggested that abnormal current accounting accruals were significantly positively related to initial credit ratings. Credit rating is considered as one of the contributing factor towards creative accounting.

Ezeani and his colleagues [13] observed that notwithstanding the international and local scandals received, the accounting officers still involve themselves in misrepresentation and malfalsification of figures of financial statement. The study also found out that the accountants and auditors indulge in creative accounting through profit eroding mechanisms in order to attract investors and resources, however the deceptive or fraudulent accounting practices often results to drastic consequences. The research data was analyzed using simple percentage method and pie chart for the research question, and t – test statistics for the hypotheses testing.

Idris and his colleagues [14] studied the practice of creative accounting, its nature, techniques, and prevention in Nigeria. They viewed creative accounting as the exploitation of accounting concepts and GAAP in order to gain various benefits and for deceitful purposes. The survey data was analyzed using the Chi-square statistic in the Predictive Analytic Software. The results showed that the practice of creative accounting was always a

calculated attempt to gain unjustifiable benefit by management and also to mislead the stakeholders of the firm, by misrepresenting the financial position of the firm.

Elias [15] established that earnings management behavior is a concern for standard-setters, regulators and the accounting profession. The study examined a sample of accounting practitioners, faculty and students and found out that there was a positive correlation between social responsibility, idealism, focus on long-term gains, and the ethical perception of earnings management. They also found a negative association between focus on short-term gains, relativism and the ethical perception of this earnings management practice. This study however did not deal with the issues on practices influencing creative accounting.

Balaciu and Pop [2] in their research highlighted some of the determinants of creative accounting which were in line with the positive accounting theory. However their study only highlights the determinants and no detailed analysis carried out. The determinants highlighted in their study did not include share price and insider dealings which also features in other studies. Sen and Inanga [3] also states one of the determinants to be share price performance. Olweny [16] found out that investor education level is significant in the determination of risk tolerance; this implies that informed investors makes better decisions and this study provided information as regards creative accounting. Further Aroni, Namusonge and Sakwa [17] observed that financial information significantly influences investor's decisions to invest in shares..Many other scholars have studied determinants of creative accounting but this study used a different approach in the analysis i.e. the multiple regression approach was employed. In addition several other studies have been carried out on techniques used in creative accounting and the ways of eliminating it. This study empirically tested the practices influencing creative accounting identified by the various studies and tested in Kenya's environment. This research therefore adds value to the existing body of knowledge on the practices influencing creative accounting among major corporations in Kenya and similar countries.

1.2. Limitation of the study

Although this thesis was theoretically conducted on a systematic basis under the supervision of qualified and specialized supervisors, there are potential limitations of this research, and the reader should be aware of these when interpreting its research findings. Nevertheless a considerable effort was made on ensuring that the objectives of this research study were met and the research questions were answered. First, the study topic is quite sensitive and most of the respondents viewed such information as confidential. The researcher persuaded the respondents by first explaining that creative accounting is not necessarily illegal. Further in order to overcome this limitation, the researcher triangulated the primary data with the secondary data. Secondly the analysis of the secondary data employed the modified Jones Model, which despite its application by many researchers has been critiqued as having some limitations such as errors related to measures of discretionary accruals. The perceived limitations observed on the model also apply to this research. Thirdly, measurement of insider dealings was a challenge since it appeared more abstract than the rest of the variables. Insider dealings information is also confidential in nature and hence a tendency of the respondents not giving the correct position on the status of affairs. Finally, there is a limitation of this research in that it investigated publicly traded companies. Therefore, it cannot be reliably used to study privately-held firms and firms not listed on NSE.

2. Methodology

2.1. Research Design

This research employed a mixed research design which is a combination of descriptive design, causal design and cross-sectional survey design. Research design is defined as the conceptual structure within which research is conducted; it comprises of the overall plan for the collection, measurement and analysis of data [18]. It assists the researcher to determine the objectives of research, subjects of research, the sample size, the data to be collected, the procedures for collecting and recording that data, the procedures for analyzing that data and how the data is interpreted and presented [19]. Descriptive design advocates for measurement of variables and hence will form the basis for causal analysis. According to Shukla [20] causal design is most appropriate when the research objectives include the need to understand why certain phenomena happen as they do. The research design employed by the study was a cross-sectional survey.

2.2. Sample Size

The target population for the study was three members of senior management from 64 Firms listed in NSE. The sample was picked on the basis of a formula by Morris [21], which was in line with the Central Limit Theorem in statistical theory which implies that any sample equal to or greater than 30 is representative enough irrespective of the population size. Consequently, the research targeted a sample of 39 companies listed in the Nairobi Securities Exchange. Interviews were conducted and questionnaires distributed to accountant, internal auditor and a manager in each of the company. The researcher managed to obtain responses from the targeted sample. The response rate therefore represents 100% of the originally targeted sample. Therefore sample size for this study for the purpose of analysis is 3 questionnaires in each of 39 companies sampled totaling to 117 responses.

3. Research Findings

The study analyzed some of the management practices that influences creative accounting among corporations listed on NSE in Kenya. Some of the practices included manager's compensation, contractual obligations, tax management and insider dealings.

3.1. Managers Compensation

The study sought to find out whether managers compensation was a practice that influence the creative accounting among the companies listed on the NSE. The researcher believed that manager's compensation may persuade the management to desire high profits for the firm so as to increase their personal benefits.

The respondents were required to indicate the level of agreement on whether Managers compensation depends on the firm's profitability. The findings are depicted by table 1.

Table 1: Managers compensation depends on the firms profitability

RESPONSE	FREQUENCY	PERCENT
Strongly Agree	10	8.55
Agree	27	23.08
Neutral	26	22.22
Disagree	39	33.33
Strongly Disagree	15	12.82
TOTAL	117	100

The table depicts that 8.55% of the respondents strongly agree that Managers compensation dependent on the firm’s profitability and 23.08% agree. 33.33% of respondents disagree and 12.82% strongly disagree. The results show that whilst there is an overall 31.63% agreement level, there was also a 22.22% neutral response, and a 46.15% disagreement with the statement. This implied that more respondents were of the opinion that manager’s compensation does not depend on the firm’s profitability.

The study results agreed with findings by Njogu and his colleagues [22] who established that there was a significant relationship between management’s earnings and creative accounting. The results were also corroborated by Dutta and Qintao [23] and were also in line with the positive accounting theories which associate creative accounting with bonus schemes and other management compensations.

Kind of benefits accruing to Top level management

The respondents were required to indicate the kind of benefits that accrues to top level management of the company. The choices provided for the respondents included Fixed Salary, Performance Bonuses, Share Purchase Options, Bonus shares, personal benefits e.g. Car and Others. The respondents were required to tick all the options that were applicable to their firms. The findings are depicted by Fig 1.

The results of the study showed that 37% of the respondents chose fixed salary option, 29% chose Performance Bonuses, 14% selected Share Purchase Options and 12% picked bonus shares. Eight (8%) selected personal benefits e.g. car and 1% selected others option. Analysis of the responses showed that all respondents picked between 1 and 5 options. Further data analysis is based on this question in the subsequent analysis is based on the number of options selected, that is, the number of benefits that accrue to the top level managers and directors. Otto [24] however found out that the value of bonus payments is higher than the value of fixed salary paid to CEOs in USA. The situation in Kenya is however different.

3.2. Contractual Obligations

The study sought to find out whether contractual obligations were a practice that influence the creative accounting among the companies listed on the NSE. The researcher believed that contractual obligations may

persuade the management to desire moderate profits for the firm so as to moderate the costs arising from debt covenants. This was in line with positive accounting theories which suggested that debt covenants plays a role in creative accounting.

The respondents were required to indicate the level of agreement on whether contractual obligations depend on the firm’s profitability. The findings are depicted by table 2.

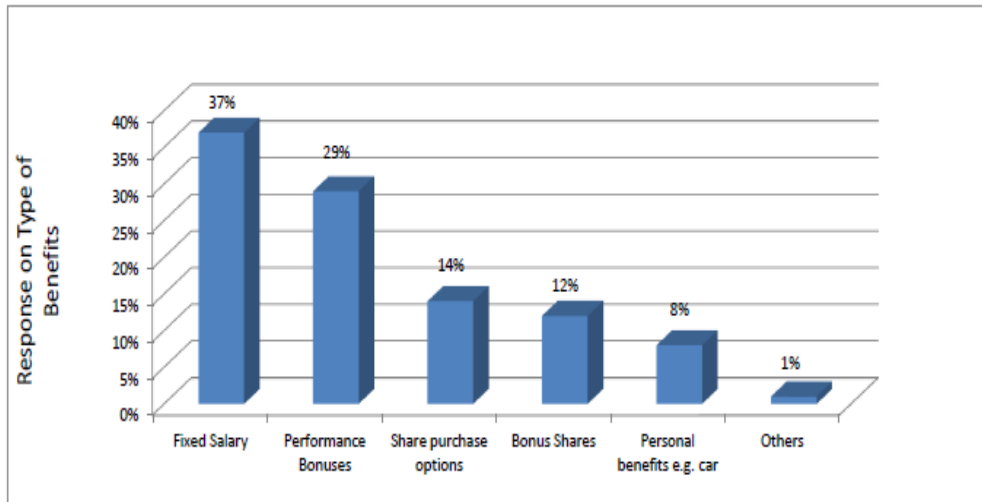


Fig 1: Kind of Benefits to managers

Table 2: Contractual obligations depends on firms profitability

RESPONSE	FREQUENCY	PERCENT
Strongly Agree	22	18.80
Agree	40	34.19
Neutral	14	11.97
Disagree	34	29.06
Strongly Disagree	7	5.98
TOTAL	117	100.00

The study indicated that 18.80% of the respondents strongly agree that contractual obligations depend on firm’s profitability and 34.19% agree while 11.97% were neutral, 29.06% disagree and 5.98% strongly disagrees. This implied that majority of the respondents (52.99%) were of the view that contractual obligations were dependent on the firms profitability, therefore suggesting that there was a relationship between debt covenants and firms profitability. The results were in line with Ramadan [25] who implied that there is a direct relationship between creative accounting and debt covenants.

3.3. Tax Management

The study sought to find out whether tax management was a practice that influence the creative accounting

among the companies listed on the NSE. The researcher believed that tax management in form of tax avoidance and evasion may persuade the management to desire lower profits for the firm so as to reduce the political costs. This was also in line with the positive accounting theories which propose that creative accounting is sometimes as a result of political costs such as taxation.

The study required the respondents to indicate their level of agreement on whether tax management is based on the firm's profitability. Gosh [1] stated that creative accounting may be employed in exchange for a variety of expected rewards among them being political gains such as tax gains. The findings are depicted by table 3

Table 3: Tax Management depends on Firms Profitability

RESPONSE	FREQUENCY	PERCENT
Strongly Agree	16	13.68
Agree	48	41.03
Neutral	11	9.40
Disagree	33	28.21
Strongly Disagree	9	7.69
TOTAL	117	100.00

The study indicated that 13.68% of the respondents strongly agree that tax management is based on firm's profitability and 41.03% agree while 9.40% were neutral, 28.21% disagree and 7.69% strongly disagrees. This implied that majority of the respondents (54.71%) were of the view that tax management was dependent on the firms profitability, therefore suggesting that there was a relationship between tax avoidance and/or evasion and firms profitability. These findings are consistent with the views held by McBarnet [26] and Cotlet *and his colleagues* [27] that creative accounting may be encouraged by the desire by management to carefully avoid tax.

3.4. Insider Dealings

The study sought to find out whether insider dealings were a practice that influence the creative accounting among the companies listed on the NSE. The researcher believed that insider dealings may persuade the management to desire high profits for the firm so as to improve the personal benefit to the management.

The study required the respondents to indicate their level of agreement on whether insider dealings depend on the firm's profitability. The findings are depicted by table 4.

The study indicated that 11.97% of the respondents strongly agree that insider dealings depend on firm's profitability and 39.32% agree while 13.68% were neutral, 28.21% disagree and 6.84% strongly disagrees. This implied that majority of the respondents (51.29%) were of the view that insider dealings were dependent on the firm's profitability, therefore suggesting that there was a relationship between insider dealings and firms profitability. The results on this question were in line with findings of Denis and Xu [28] who stated that

insider trading allows insiders to profit from their innovation and effort, meaning that there is a correlation between insider dealings and firm's profitability.

Table 4: Insider Dealings depends on Firms Profitability

RESPONSE	FREQUENCY	PERCENT
Strongly Agree	14	11.97
Agree	46	39.32
Neutral	16	13.68
Disagree	33	28.21
Strongly Disagree	8	6.84
TOTAL	117	100.00

4. Conclusion

The aim of this study was to evaluate the influence of practices that induces the firms to engage in creative accounting among companies listed on the NSE in Kenya. The results obtained by the study indicate that there is a relationship between manager's compensation, Contractual obligations, tax management & insider dealings and creative accounting among the listed companies on the NSE.

Generally more than half of the respondents were in agreement that manager's compensation was a practice that could influence creative accounting among the forms listed on NSE. This evidences show that manager's compensation among listed companies in Kenya is high and dependent on the firm's profitability. These results were consistent with the observations of Beaudoin and his colleagues [29] who established that managers use accounting discretion to manage earnings, in order to maximize their cash bonuses. Further more than half of the respondents were in agreement that contractual obligations were a practice that could influence creative accounting among the forms listed on NSE. These findings agree with the most of the literature reviewed. Oluoch and his colleagues [30] as well as Omoro and his colleagues [31] supports the results of this study contractual obligation related practices may lead to creative accounting. In addition more than half of the respondents were in agreement that tax management was a practice that could influence creative accounting among the forms listed on NSE. The results in this section was in line with findings by Sanusi and Izedonmi [32] and Lin, Lu and Zhang [33] who expressed that firms create accounts with aim of saving taxes. Kamau et al [34] also established that tax management was a major contributor to creative accounting among the medium sized firms. Finally insider dealing practices among companies listed on NSE found not to be high. This generally meant that more than half of the respondents were not in agreement that insider dealings was a practice that could not influence creative accounting among the forms listed on NSE. This was in agreement with Iraya and his colleagues [35] observed that transactions by insiders have an effect on earnings management. This paper is an extension to our study on practices influencing creative accounting among companies listed on NSE [36].

5. Recommendations

Following the findings of the study and the implications on the accounting practices influencing creative accounting among listed companies on the Nairobi Securities Exchange, the study gives the following recommendations.

- a) Issuance of extended audit reports by the independent auditors should be encouraged. This comes from the finding in this study that all the sampled companies received unqualified audit reports despite some indication that creative accounting may be occurring in such firms.
- b) Improved corporate governance for improving financial reporting quality and to increase the confidence of investors in company's financial report. Issues of insider dealings and tax management can be greatly reduced through proper governance processes.
- c) The organizations may consider avoiding performance based compensation system so as to reduce the temptation of influencing the earnings figure through creative accounting
- d) In some instances managers may engage in creative accounting so as to improve credit rating in an attempt to attract investors. This form of creative accounting is commonly referred to as window dressing. Competent auditors should be in a position to detect this practice while ethical auditors should be able to report that the financial statements show true and fair view of the company state of affairs as at the reporting date.
- e) Accountants, clerks and bookkeepers take a certain amount of ethics courses each year. In addition, creative accounting should be introduced to the curriculum for accounting students in order to stress on the ethical aspects of accounting.
- f) Organizations should also maximize use of internal audit department which is instrumental in monitoring governance, risk management and control processes. Presence of active and independent internal audit department can play a key role in sealing internal control weaknesses which can be exploited by the perpetrators of creative accounting.

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