Corporate governance and creative accounting

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Abstract:
Through this study we will try to shed light on the role of corporate governance as a control system, to reduce the effects of creative accounting on the reliability of accounting information directed to the stakeholder’s interests. this paper describes the literature review of the relationship between corporate governance and creative accounting, present the theoretical framework proposed for the understanding of creative accounting practices, the main parties to creative accounting and its methods, define the role of corporate governance in detecting creative accounting practices. It provides for the total academics the theoretical framework for the creative accounting practices and shows for students the importance and the need to address this type of practice, using the control system, and confirms that corporate governance is the most important defense line to reduce these practices.

Keywords: Creative Accounting, Corporate Governance.

INTRODUCTION:

When accounting was created as an "art" that means to register and classify economic business events, it was evolved into a "science" governed by a general framework of principles, assumptions and concepts, whereas accounting an art, it is by understanding the nature of accountant , behavior of stock market and dealers, it became able to draw financial reporting and carved profits desired by management, led by the motivation to maximize the current or future rewards, but when the companies discovered that laws only tell you what it cannot do, and not what you can do, it decided to choose what you can make it as a playground to score goals, if you cannot earn profits, you can at least create them!!! It is “the financial numbers game”, and called in the accounting literatures “creative accounting”. But it is worth noting that some of these practices are very legitimate and other are opposite, the latter considered as shading and misleading with a cloak of law. Hence, the conflict of interest intensified between the agency parties, management and owners, and when confidence to financial statements collapsed, it became necessary to think of solutions to this problem, before that specialists found only the adoption of an effective regulatory system called "corporate governance". The financial reporting scandals giving rise to Sarbanes-Oxley (SOX) act of 2002 generated significant concerns not only because of the size of failures and irregular accounting practices but also because they cast doubt on the ability of corporate governance participants to prevent, deter, and detect material financial malfeasance.
The purpose of this article is to bring together several components in order to construct an answer to the following question:

‘What is the relationship between corporate governance system and creative accounting practices?’

Through this study we will try to shed light on the role of corporate governance as a control system, to reduce the effects of creative accounting on the reliability of accounting information directed to the stakeholder’s interests. Our paper is organized as follows; Section one describes the literature review of the relationship between corporate governance and creative accounting, in the Section two we present the theoretical framework proposed for the understanding of creative accounting practices, in the section three we present the main parties to creative accounting and its methods, in the section four we are going to find the role of corporate governance in detecting creative accounting practices.

**Literature review in the relationship between corporate governance and creative accounting:**

Corporate governance is concerned with the relationships between a business’s management and its board of directors, shareholders and lenders and its other stakeholders such as employees, customers, suppliers, and the community in which activates. The connection between this topic and creative accounting was debated in the literature since the latter occurrence is related to the weakness of the first. Both concepts are treated in the literature extensively and the difference employed regards the perception of each. While the first concept is treated and accepted as having a general meaning, the latter is considered to be controversial in terms of meanings and acceptance.

**Literature based on the relevant empirical work that documented the association of corporate governance and creative accounting:**

The pioneering studies in accounting area that investigated the relationship between information asymmetry and earning management were conducted by Dye (1988) and Trueman and Titman (1988), who asserted that the existence of information asymmetry is the necessary condition for earnings management. With this study, information asymmetry is brought directly in accounting area since it was associated with manipulative behavior. Since then and to the present times, information asymmetry is regarded in the accounting literature just the same. Schipper (1989) also approached the relationship between the information asymmetry and earnings management and concluded that when information asymmetry is high the shareholders and stakeholders do not have sufficient information, resources, incentives or access in order to monitor manager’s actions fact that gives rise to earnings management practices. The same opinion is shared by Warfield, Wild and Wild (1995) who tested this hypothesis in a broad sample setting as well as around seasoned equity offerings. The results in a broad sample setting suggested a significant, positive relationship between earnings management and information asymmetry. Those results are consistent with the fact that the greater information asymmetry is between the managers and its shareholders the more likely the company is engaged in earnings manipulations. Others results of the studies conducted around seasoned equity offerings serves as a second setting to test the relationship between information asymmetry and earnings management. The empirical study conducted Rangan (1998), indicate the fact that management faces the incentives to manage the earnings upward prior to seasoned equity offerings in order to maximize the offer prices of the shares. This is a proof that they are willing to focus on short-term objectives rather on long-term objectives. Richardson (2000) tested the hypothesis that the magnitude of information asymmetry affects the magnitude of earnings management practiced by firm’s managers. The author conducted a direct test of Dye (1988) and Trueman and Titman (1988) theory that the presence of information asymmetry is a necessary condition for earnings management and extended the argument by introducing the relationship between them assessed in
terms of magnitude. The tests of the hypothesis provided evidence of the predicted positive relationship between information asymmetry and earnings management. Positive association was also documented between the quality of corporate governance and earnings management in the study conducted by Ali Shah, Ali Butt, Hasan (2009).

When those two topics are treated simultaneously (e.g. corporate governance and creative accounting), the third topic of information asymmetry between firms and other stakeholders arise. In this context the studies comprised in the literature also examined the way in which “gatekeepers are monitors that are supposed to alleviate the information asymmetry”, like: analysts, institutional shareholders who are blockholders and activists, boards of directors and their audit committees, auditors, the press, and investment bankers, and credit agencies.

The role of corporate governance complex mechanism is to minimize information asymmetry and to ensure compliance with mandated reporting requirements while maintaining the credibility of a firm’s financial statements and safeguard against manipulative behavior.

Corporate managers in their fiduciary role as the stewards of stockholders’ assets are expected to run the company primarily in the best interest of the providers of the capital and as a consequence should focus to maximize long-term earnings correlated with improved business strategies, objective successful operations and sustainable development.

When corporate governance area intersects with creative accounting presented under all its forms of manifestation, information asymmetry is not the only problem involved. The fact that managers tend to focus on short-term personal incentives (e.g. enhance market value of the stock for stockholders or to increase income-based compensation for management like bonuses or maximizing salaries) rather than focus on long-term economic success of the firm could harm seriously the future of the firm. This particular vision is usually accompanied with aggressive use of manipulating techniques which causes the topic of creative accounting to rise to a level of importance in the area of corporate governance and not only. Dechow et al., (1996) issued a part of the previous opinion based on their empirical study that documented a strong association between earnings management occurrence and the lack of features of a strong corporate governance, features as: the absence of an audit committee; the combination of the CEO and founder roles; the combination of the CEO and the chair of the board roles; board of directors dominated by insiders; and absence of an external block holder (i.e. watchdog) monitoring management. Further studies sustain their opinion.

Since the most prominent accounting scandals were in USA, the change of corporate governance mechanisms came also from this accounting environment. As we approach above, two events changed the corporate governance mechanism and from this point the corporate mechanisms all over the world changed. First regulation event took place in July 2002, when the USA adopted the Sarbanes-Oxley Act which applies to all public companies with stock traded in the United States. Among its many provisions, the Sarbanes-Oxley Act required substantial change of vision when required that a company’s board to have a majority of independent directors and that the board's audit committee consist entirely of independent directors, further to have at least one member with financial expertise and to restrict the types of non-audit services that the outside auditor can provide (all these changes were adopted based on accounting scandals experience). The second event took place in the end of 2003 when the biggest capital markets in the world (e.g. NYSE, NASDAQ, and AMEX) adopted new sets of corporate governance rules that apply to most of their listed companies. Their rules were based on Sarbanes-Oxley Act and were designed to avoid serious accounting problems in the future.

In 2005 an empirical study was conducted by Agrawal and Chadha with the main goal of examining if corporate governance mechanisms are related to the possibility of a company restating its earnings. After examining a sample of 159 U.S. public companies that restated earnings the authors compared the results with an industry-size matched samples of control firms and concluded that several key governance characteristics are essentially unrelated to the probability of a company restating earnings. These include the
independence of boards and audit committees and the extent to which outside auditors provide non-audit services to a firm. This empirical study is important having the fact that it demonstrates the fact that the prominent changes to corporate governance mechanisms have achieved its goals.

In the light of accounting scandals such as Enron and subsequent regulatory reforms like those introduced by the Sarbanes-Oxley Act of 2002, various studies had been conducted in the area of accounting and auditing, examining the role of corporate governance and various features of this complex mechanism. Most of the studies are focused on Agency Theory, and examined how the monitoring roles of the board and the audit committee have been used to protect or fail to protect stockholder rights. What most of those studies have in common is the fact that they ignore the effect management may have on the governance process and sustain that independent boards must monitor management actions. Since those studies are based on Agency Theory the fact that they let out of discussion the role of management is not hard to predict since the role of management in corporate governance is somewhat inconsistent since the theory suggests that governance parties must monitor and thus be independent of management.

In response of accounting irregularities the frameworks for corporate governance in USA and elsewhere was re-examined. Among the key standards for international financial architecture that were modified were also the OECD Principles of Corporate Governance (that covers certain aspects of accounting and auditing in relation to corporate governance) considered to be essential to the soundness and stability of financial systems and as having a key role in measures to strengthen international financial architecture.

Five basic subjects are covered by the OECD Principles of Corporate Governance as following:

- Protection of the rights of shareholders;
- Equitable treatment of all shareholders comprising full disclosure of material information and also the prohibition of abusive self-dealing and insider trading;
- Equitable treatment of all stakeholders as established by law and encouragement of cooperation between company and stakeholders;
- Timely and accurate disclosure and transparency with respect to matters material to company performance, ownership and governance;
- Strategic guidance of the company and effective monitoring of its management by the board of directors as well as the board’s accountability to the company and its shareholders ensured by the corporate governance framework.

If we assess the Enron scandal having as a bases those principles we can conclude that most of them weren’t respected. The lack of transparency was the main item that contributed to the breakdown of corporate governance in regarding of this particular company. Key items of Enron’s lack of transparency were represented by the manipulation of both its earnings figures and its balance sheet; manipulation that involved extensive use of creative accounting techniques like: special purpose entities, hedges and mark-to-market accounting.

**Literature based on corporate governance features that sustain the connection of the concept with creative accounting documented in empirical works:**

The empirical studies that associated corporate governance with creative accounting were interested in assessing the role of the first in the occurrence of creative accounting and to assess empirically its magnitude. Studies like those conducted by Rajgopal et al., (1999); Beekes et al. (2002); Agarwal and Chadha (2005) are representative in this respect. In any of those studies, various components of corporate governance mechanism are discussed in association with creative accounting features.

The study conducted by Rajgopal et al. (1999), tests the impact on earnings management by institutional ownership. The empirical study conducted by Agarwal and Chadha (2005) tested for association between accounting restatements and the board of directors and the audit committee concluding based on their regression that there is a positive association.
Beekes et al. (2002) examined the relationship between board of directors and accounting quality concluding that the first category has the power to influence the latter. Jensen (1986) asserted that managers occasionally strive to defeat takeover activities by making their firm presume more debt. In this respect the author explains that takeovers can be for managers an unwanted demarche having the fact that this employs new ownership and established new management. The managers cab fight against this by increasing the level of debts and reduce the probability of taking place new offers for the existing shareholders. Other aspect that was examined was the debt contact constrains in association with opportunistic behavior. Large stock shareholders are considered the most important group in the company and two features defines them: they are the most informed investors and they are interested in long-term performance of the company. Managers for improving their remuneration packages are interested in performing creative activities that in long term can affect the part of the rewards designated to those particular investors. In this context, the first category will is not interested in earnings management activities and will have more motivation to accomplish monitoring activities. Auditor independence is seen in the literature as a possible root for creative accounting occurrence. In this respect, Kinney et al., (2004), examined the non-audit fees paid to auditors and concluded that high non-audit fees paid to auditors are more likely to be related to creative accounting compared to high audit fees, as non-audit tasks produces higher profits than audit tasks. Frankel, Johnson and Nelson (2002) also documented a positive association between non-audit fees and earnings surprises and magnitude of discretionary accruals. Becker et al. (1998) documented that small audit firms showed high discretionary accruals in the accounts compared to large auditing firms and concluded that the latter category is more effective in limit opportunistic behaviors that the first one. The study of the Becker et al., (1998) was conducted based on the believe that large audit firms with good brand name select their clients very good and will always chose the clients that are not engaging in creative accounting techniques. The independence of the board of directors is associated with protecting the interests of shareholders and election of top management. According to Fama and Jensen (1983) the company’s directors should keep a status by employing skill personnel who can take best decisions as well as execute those decisions promptly. In this context, creative accounting is considered to be negative associated with this particular feature of corporate governance. Lai and Tam (2007) conducted an empirical study in order to examine the impact of independent board of directors over the propensity of smoothing earnings and the conclusions revealed that Chinese firms that voluntary adopted independent directors as well as firms that have larger fraction of independent directors have less severe practice of income smoothing. Auditor industry expertise was assessed in association with earnings management by Krishnan (2003) who documented that specialized auditors (measured in terms of both auditor market share in an industry and an industry share in the auditor’s portfolio of client industries) mitigate accruals-based management more than non-specialist auditors influencing positively the quality of earnings. The independent board can be a factor that has the power to restrict creative accounting until this is not related to the incentives offered to independent directors. In this respect, stock options schemes are calculated based on firm profitability. If this decreases managers may engage in manipulative schemes and the independent directors may tolerate this kind of behavior by not disclosing it. According to Bartov and Mahanram (2004), many top management directors have the incentive to time their stock option in such a way that it is exercised and then information is disclosed. The empirical study conducted by Meek, Rao and Skousen (2007) documented a positive relationship between CEO stock option compensation and discretionary accruals this implying that earnings management is more likely where stock options are a larger part of CEO compensation. When it comes to management remuneration, this is strongly connected to the financial performance of the company and as a consequence of this fact; the more profitable a company is the highest rewards managers will receive. In this respect, Healy (1985) sees this
association as having the power to generate earnings management schemes. This vision is similar to Guidry et al. (1999) vision, as the latter documented that for receiving maximum bonus, managers make use of accrual decisions that boost the profitability.

Internal audit was also examined in association with the level of earnings management. The study conducted by Prawitt, Smith and Wood (2009) assessed the influence of internal auditors on earnings management occurrence measured by two separate proxies like: abnormal accruals and the propensity to meet or beat analysts forecast. The results of the empirical study documented that internal audit quality (measured based on their role in financial reporting) is associated with a moderation in the level of earnings management measured by the above proxies.

Most of those factors are considered corporate governance tools designed to restrict creative accounting but still some of them inspire it (e.g. management remuneration). Having the various misdeeds in accounting the importance of corporate governance instruments increased over time (Alina, B. D, Matis, 2010).

In the following figure we summarized various corporate governance factors that were examined in association with creative accounting in the literature:

The Theoretical Framework Proposed for The Understanding of Creative Accounting Practices:

Creative accounting is nothing new, it has been a temptation and a problem from the moment that accounting principles were first used to report on business performance. There is an old joke about the accountant who is asked to add up two and two and who produces the response ‘What would you like the answer to be?’ It is an appropriate reminder that financial measurement is not an exact science (Kevin, A. Alan, W. 2003:3).
Creative accounting is referred to also as income smoothing, earnings management, earnings smoothing, financial engineering and cosmetic accounting.

Definitions of creative accounting vary, and include the following:

‘It is the deliberate dampening of fluctuations about “some level of earnings considered being normal for the firm”’ (Barnea et al, 1976).

‘creative accounting is any action on the part of management which affects reported income and which provides no true economic advantage to the organization and may in fact, in the long-term, be detrimental’ (Merchant and Rockness, 1994).

‘creative accounting involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, the effect of which is to report a stream of income with a smaller variation from trend than would otherwise have appeared’ (Copeland, 1968).

‘Creative accounting practices are any and all steps used to play the financial numbers game, including the aggressive choice and application of accounting principles, both within and beyond the boundaries of generally accepted accounting principles, and fraudulent financial reporting .Also included are steps taken toward earnings management and income smoothing’ (Charles W, Mulford. E, Comiskey, 2002:15).

In this paper we will prefer according to the previous definitions, to consider that creative accounting involves using the flexibility in accounting within the regulatory framework to manage the measurement and presentation of the accounts so that they give primacy to the interests of the preparers not the users.

Authors like Stolowy and Breton (2003) are among the few interested in the subject of creative accounting daring to suggest a theoretical framework for the understanding of the accounting manipulation practices. The fundamental principle which their theoretical framework is based on is the following: the aim of publishing financial information is that to reduce the costs of the enterprise projects financing. But this reduction depends on the risks to transfer the riches as they are perceived by the agents on the market. The practical means to operate these transfers are based on the results and the balance between the debts and share capital. Consequently, the purpose of accounting data management is to change these two measures: the variation of the result per share and the relation liabilities/assets. The result per share can be changed in two ways: either adding or subtracting certain profits or expenses (which represents the change of the net result) or transferring a column from the upstream or the downstream of the results serving as a computation base of the result per share (which is the management through classification). Regarding the relation between liabilities and assets, this can be modified by increasing the benefit or hiding certain financings with the help of engagements generating devices, off the balance sheet.

Figure 2 represents the theoretical framework proposed by Stolowy and Breton for the understanding of the accounting data management (Diana,B. Victoria,B .Alina, B, 2009):
The Theoretical Framework Proposed By Stolowy and Breton for the Understanding of the Accounting Data Management.

The Main Parties to Creative Accounting and Its Methods:

Creative accounting does not occur in a vacuum, there are a number of interested parties, and ways used.

**The main parties:**

The main parties to creative accounting range from managers, investment analysts, auditors, regulators, shareholders, merchant bankers to other users, as can be seen from Figure 3, all of these parties play a key role in creative accounting (Michael, J, 2011:28):

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**Figure “3”**

**The Main Parties to Creative Accounting.**


The managers set the creative accounting agenda, they wish to portray the accounts in a light of favorable to themselves, this may be to increase net assets, and the flexibility in accounting allows them to select accounting techniques which can deliver the profit figure that serves their interests. Managers may take professional advice from, for example, merchant bank to devise creative accounting schemes, while complying with the letter of the law, transgress its spirit. Regulators seek to control and limit creative accounting by setting rules and regulations, over time, the regulatory framework will be shaped by creative accounting and will in turn shape creative accounting. Meanwhile the auditors will seek to ensure that the accounts are true and fair, by relying on regulators. Auditors use creative accounting to portray the accounts in a light favourable to themselves. Investment analysts are seeking to price stocks and shares efficiently, they will, therefore, seek to adjust the accounts for creative accounting. For ordinary shareholders, creative accounting can affect the share price and they will also wish to try to detect it. If a company gets into difficulties or, even worse, goes bankrupt, they will be major losers. Finally, bankers and
The potential for creative accounting is found in six principal areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgment in respect of assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers. Even in a highly regulated accounting environment such as the USA, a great deal of flexibility is available (Mulford, and Comiskey, 2002:15). Taking each of the six areas in turn:

- **Regulatory flexibility:**
  Accounting regulation often permits a choice of policy; for example, in respect of asset valuation (International Accounting Standards permit a choice between carrying non-current assets at either revalued amounts or depreciated historical cost). Business entities may, quite validly, change their accounting policies. As Schipper (1989) points out, such changes may be relatively easy to identify in the year of change, but are much less readily discernible thereafter.

- **Dearth of regulation:**
  Some areas are simply not fully regulated. For example, there are (as yet) very few mandatory requirements in respect of accounting for stock options. In the majority of countries, like Spain for example, accounting regulation in some areas is limited: for example the recognition and measurement of pension liabilities and certain aspects of accounting for financial instruments.

- **Management has considerable scope for estimation in discretionary areas:**
  McNichols and Wilson (1988), for example, examine the discretionary and nondiscretionary elements of the bad debts provision. Genuine transactions can also be timed so as to give the desired impression in the accounts: As an example, suppose a business has an investment at historic cost which can easily be sold for a higher sales price, being the current value. The managers of the business are free to choose in which year they sell the investment and so increase the profit in the accounts.

- **Artificial transactions can be entered into both to manipulate balance sheet amounts and to move profits between accounting periods:**
  This is achieved by entering into two or more related transactions with an obliging third party, normally a bank. For example, supposing an arrangement is made to sell an asset to a bank then lease that asset back for the rest of its useful life. The sale price under such a 'sale and leaseback' can be pitched above or below the current value of the asset, because the difference can be compensated for by increased or reduced rentals.

- **Reclassification and presentation of financial numbers are relatively under-explored in the literature:**
  However, the study by Gramlich et al. (2001) suggests that firms may engage in balance sheet manipulation to reclassify liabilities in order to smooth reported liquidity and leverage ratios. A special type of creative accounting relates to the presentation of financial numbers, based on cognitive reference points. As explained by Niskanen and Keloharju (2000): ‘the idea behind this behavior is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million’. Their study and others (e.g. van Caneghem, 2002) have indicated that some minor massaging of figures does take place in order to reach significant reference points (Oriol, A. Catherine, G, 2004).

We will now discuss some of the main methods of creative accounting. Generally, the techniques presented here will be methods of creative accounting:

**Strategy 1: increase income**

There are five most common methods for increasing income:

- Premature sales recognition,
- Increase interest receivable,
- Include non-operating profits,
- Treat loans as sales,
- Swaps,

Strategy 2: Decrease expenses

The major other strategy to increase profit is to decrease expenses, there are probably even more ways to do this than to increase sales, these are:
- Use provision accounting,
- Reduce tax,
- Big bath or excessive one-year write-off,
- Decrease expenses and increase assets,
- Increase closing inventory,
- Capitalise expenses,
- Lengthen depreciation lives,
- Be generous with bad debts,

Strategy 3: Increase assets

The first method of strengthening a balance sheet is to increase the assets, many of the techniques in strategy 2 also indirectly had this effect, and however under this strategy we cover those techniques which are focused mainly on improving the asset base rather than on increasing profit:
- Enhance goodwill,
- Enhance brands and other intangibles,
- Revalue fixed assets,
- Mark-to-market,

Strategy 4: Decrease liabilities

The second method of increasing balance sheet values is to reduce liabilities, the two main methods of doing this are:
- Off-balance sheet financing,
- Reclassifying debt as equity,

Strategy 5: Increase operating cash flows

The cash flow of a business is much harder to massage than its profit, this is because generally, cash is subject to mush less estimation than profit. However sometimes in unusual circumstances companies will be able to accelerate cash flow from a later period to an earlier period. There are two ways of presenting the cash flow statement: the direct method and the indirect method, the direct method records actual cash inflows and outflows. The indirect method is harder to follow for the uninitiated but tends not to focus so much on the cash flows. It divides the flows by function, such as operating cash flows, investing cash flows or financing cash flows. In particular, it focuses on operating cash flows which are the main concern of the analysts; most companies present the cash flow statement using the indirect method. This may be because it gives them more flexibility; it is prepared from the existing income statement and the last two years’ balance sheet. The focus is generally on operating cash flow, there are two main methods which both focus on massaging operating cash flows,
- Maximize operating cash inflows,
The Role of Corporate Governance in Detecting Creative Accounting Practices:

The definition of corporate governance most widely used is "The system by which companies are directed and controlled" Cadbury Committee, (1992).

More specifically it is the framework by which the various stakeholder interests are balanced, or, as the International Finance Corporation (IFC states), "The relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders.

The OECD (Organization for Economic Cooperation and Development) Principles of Corporate Governance states: "Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

It is important for companies to develop an effective model of corporate governance that will enable them to take advantage of opportunities that may arise, whilst at the same time instituting the necessary controls over associated risks. The rules and standards of corporate governance are considered to be important factors in the creation of prosperous market economies.

Corporate governance consists of a set of rules and conduct in accordance with which companies are managed and controlled. It usually involves the mechanisms by means of which company manager’s answer for the due and proper running and performance of the company. The company represents the assets of all the shareholders and in the long term the interests of the company necessarily converge with those of its shareholders.

“Control” implies effective evaluation of performance, careful management of potential risks, and proper supervision of agreed procedures and processes.

In this respect the emphasis here is on monitoring whether robust control systems are operating effectively, whether potential conflicts of interest are being managed and whether sufficient checks are in place to prevent abuses of power that may allow personal interests to prevail over corporate interests (Karine, J. Bertrand M, 2001:9).

**Corporate governance functions:**

Corporate governance is a broad concept consisting of a set of external and internal mechanisms designed to align interests of management with those of shareholders and to ensure compliance with applicable laws, rules, and standards. Corporate governance play an important role in improving investor confidence in financial reports and capital markets by focusing on three institutional factors:

- Ownership structure,
- Legal system,
- Capital markets,

The seven essential corporate governance functions are:

- Oversights function: it is granted to the board of directors with the fiduciary duty of overseeing the alignment of the managerial function with the best interests of the company and its shareholders.

- Managerial function: management is given the authority to run the company and manage its resources and operations.

- External audit function: external auditors express an opinion that financial statements truly and fairly represent, in all material respects, the company’s financial position and the results of operations in conformity with accounting standards and principles.
– Internal audit function: this function provide both assurance and consulting services to the company in the areas of operational efficiency, risk management, internal controls, financial reporting, and governance processes.

– Compliance function: this function is composed of a set of laws, regulations, rules, standards and best practices developed by state and federal legislators, regulators, standard-setting bodies, and professional organizations to create a compliance framework for public companies in which to operate and achieve their goals.

– Legal and financial advisory function: this function provides legal advice and assists the company, its directors, officers, and employees with complying with applicable laws, regulations, rules, and other legal obligations and fiduciary duties.

– Monitoring function: this function is exercised by shareholders, particularly institutional shareholders, who are empowered to elect and, if warranted, to remove directors. (Zabihollah, R. Richard, R, 2010:132)

The role of corporate governance in detecting creative accounting practices:

A company needs effective corporate governance to reduce the likelihood of creative accounting and, in particular, fraud. This involves effective internal controls and effective independent scrutiny of the executive directors by non-executives. In particular, there are perhaps four main areas which a company ought to pay attention to in order to mitigate the risk of fraud: effective internal controls, the division of responsibility between chief executive and chairman, an audit committee and representation on the board of directors.

– Effective internal controls: Internal control includes a control environment n risk assessment and management, monitoring and control activities. The presence of strong controls inhibits the possibility of financial malpractice. The collection of controls provides a key mechanism, combined with internal audit, whereby malpractice can be minimized.

– Division of the responsibility between chief executive and chairman:
One person being both chairman and chief executive is particularly dangerous. This is an essential division of authority in the board room. It prevents the unmitigated exercise of power by one person.

– Audit committee:
The audit committee is a relatively new development. It is responsible for supervising the auditors. It is important that the audit committee, to be effective, is independent; in particular, not staffed by friends, acquaintance or family members of existing executive directors. It also needs to meet frequently and to be staffed by experienced individuals.

– Independent board of directors:
There is a need for the board of directors itself to be strong. To be effective, there need to be independent non-executive directors. As with the audit committee, the board of directors should not be friends, acquaintances or family members of existing executive directors (Michael, J, 2011:35).
Conclusion:

All in all, the various parties to creative accounting have mixed interests, some would appear actually to benefit from creative accounting, managers because it gives them the flexibility to deliver the results they want to present; existing shareholders, unless the company collapses, because it may increase the share price, and finally, merchant bankers, because they can earn potentially huge fees peddling and devising complex creative accounting schemes.

By contrast, certain other groups are harmed. Regulators dislike creative accounting because it can be used to bypass accounting rules and regulations and this undermines the credibility of the account. Auditors are scared that if creative accounting contributes to a company’s collapse, they will be blamed and held negligent. Shareholders and other users may also suffer if the company collapses. Suppliers and bankers may get a false sense of security when accounts have been subject to creative accounting. Finally, employees might be misled by a company’s results. To avoid creative accounting, it is necessary to have good corporate governance. Four elements of corporate governance are particularly important: strong internal control, the separation of the posts of chief executive and chairman, the existence of an audit committee and the presence of independent directors. So we need an effective corporate governance system to limit creative accounting cases.

References:


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