Determinants of auditors’ attitudes towards creative accounting

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Abstract
Smith (2003) responded to the Sarbanes-Oxley Act by suggesting that government rules and regulations cannot preserve a profession where people lack integrity. He suggests that leaders in the profession and academe “call individuals to excellence” and “inculcate in practitioners and students ethical behaviour and personal integrity”.

This study investigates whether auditors’ attitudes towards creative accounting are associated with ethical judgement, their evaluation of the quality of financial reporting and their perceptions of factors that influence preparers of financial statements to use aggressive accounting techniques. The results of this study reveal a significant relationship between auditors’ assessments of the relevance and reliability (but not ethical judgement) of reported information and their attitudes to creative accounting. Some insight is gained into auditors’ perceptions of the factors that influence preparers to use creative accounting in South Africa.

Key words
Creative accounting
Ethics
Qualitative characteristics
South Africa

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1 Introduction

1.1 Objective and background
The purpose of this article is to investigate whether auditors’ attitudes towards creative accounting are associated with their evaluation of the quality of financial reporting, their perceptions of factors that influence preparers of financial statements to use aggressive accounting techniques and their own ethical judgement.
The demand for independent audit services originated in the 18th century when management took advantage of the separation of management and ownership functions to indulge in opportunistic behaviour. However, independent audits of publicly traded corporations were only established in America by the Securities Exchange Commission (SEC) in 1937; independent auditors performed their audits in accordance with established auditing practices and procedures and attested to the fairness of management’s financial reports to shareholders and note any deviations from Generally Accepted Accounting Principles (GAAP) (Imhoff 2003:117).

In South Africa, company law obliges company directors to prepare annual financial statements that fairly present the state of affairs of a company in conformity with generally accepted accounting practice; interpreted as compliance with GAAP in Circular 08/99 par.15 (SAICA:1999). The auditor’s duty to attest to the fairness of the financial statements and report any deviations from GAAP is established in the Companies Act, No 61 of 1973:S300(i) and S301 (South Africa 1973). Therefore, where management has used creative accounting to exploit loopholes in the rules in order to present a deliberately misleading impression (Alexander & Archer 2003:12), auditors need to make decisions about issuing an unqualified audit report where such creative accounting practices are not adjusted.

In the financial reporting environment, auditors’ attitudes towards creative accounting are shaped by Statements of Generally Accepted Accounting Practice (GAAP), the qualitative characteristics identified in the Framework for the Preparation and Presentation of Financial Statements (the Framework) (IASB 2001) and the Code of Professional Conduct (the Code) (SAICA:2002). In addition, it can be assumed that auditors are aware of financial statement preparers’ motives for using aggressive accounting techniques and that they will be cautious in their evaluation of the faithful representation of the financial statements in these circumstances.

The objective of financial statements, established in the Framework (IASB 2001:par.12), is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. The qualitative characteristics are the attributes that make the information provided in financial statements useful to users of such statements (IASB 2001:par.24) and are to be considered by preparers of statements when they are choosing accounting policies, making decisions relating to the timing and recognition of transactions and the presentation of information in the financial statements. ISA 700, as presented by the International Accounting and Assurance Standards Board (IAASB 2003), requires that auditors consider whether the information presented in financial statements adheres to certain qualitative characteristics when they form an opinion on whether the financial statements fairly present the financial position, performance and changes in the financial position of a company.

Professions need a code of ethics to assure the public and clients of its responsibilities and thereby maintain their integrity and reputation (Velayutham 2003:483). In South Africa, the responsibilities of accountants and auditors are established by the Code of Professional Conduct (SAICA 2002:11).

1.2 Motivation
Recent accounting scandals, for example, the Macmed, Leisurenet and Regal Bank cases, provide evidence that creative accounting can occur within this legislative framework.
Therefore it is appropriate to investigate whether auditors’ attitudes towards creative accounting are associated with their evaluation of the quality of financial reporting, their perceptions of factors that influence preparers of statements to use aggressive accounting techniques and their own ethical judgement.

This study is exploratory in nature as the proposed relationships between auditors’ attitudes towards creative accounting, their evaluation of the quality of financial reporting, their perceptions of factors that influence preparers of statements to use aggressive accounting techniques and their own ethical judgement (the constructs in this study) is speculative in nature. However, intuition suggests that if the regulatory frameworks are effective in forming auditors’ attitudes towards creative accounting, a relationship between the constructs should exist. This relationship was tested using the partial least squares approach (PLS) to structural equation modelling, as this approach is appropriate where a set of asymmetrical relationships is proposed that may be based on hypotheses derived from embryonic theory (see Falk & Miller 1992:9).

The results of this study are useful in the South African context, as no previous studies have investigated auditors’ attitudes towards creative accounting practices and their assessment of the factors that influence preparers of statements to use earnings management techniques.

South Africa is an emerging economy, but one which Nair and Frank (1980) describe as having developed accounting and measurement practices. However, the enforcement of compliance with GAAP in the South African reporting environment is still in its infancy, and it differs from that in the United States and Britain; intuitively one might expect this to influence auditors’ attitudes towards creative accounting. In South Africa, compliance with GAAP does not yet enjoy formalised legal backing; however, all listed companies are required to comply with GAAP in terms of the JSE Securities Exchange South Africa (JSE) listing requirements. GAAP compliance of listed companies is enforced by the GAAP Monitoring Panel (GMP), which has been established by the South African Institute of Chartered Accountants (SAICA) and the JSE. The GMP is a reactive body and it evaluates the financial statements of companies reported to it for GAAP violations.

In the United Kingdom (UK), the Financial Accounting Review Panel (FRRP) is responsible for the enforcement of GAAP and company law in respect of public limited companies and large private companies. The FRRP is a reactive body; the sources for its cases are qualified audit reports, press comments and referrals from individuals. The FRRP has legal powers to seek court orders against company directors to require them to re-issue financial accounts in order to remedy identified cases of non-compliance. This contrasts with the monitoring structure in the United States of America (USA), where the financial statements of all companies listed on national securities exchanges are scrutinised by the Securities Exchange Commission (SEC), an independent federal regulatory agency, to ensure compliance with GAAP set by the Financial Accounting Standards Board (FASB).

1.3 Limitations

This study is based on the replies of 40 respondents. The low number of respondents made it difficult to test the measurement model; therefore the relationships between the constructs and their manifest variables could not be explored fully. In addition, as this study is based solely on participants’ responses to scenarios designed to evaluate their attitudes towards
controversial issues, there is a risk that the respondents may not have answered the questionnaire honestly, as discussed by Flory, Phillips, Reidenbach and Robin (1992:295).

The remainder of the paper is arranged as follows: the first section discusses ethical judgement, the qualitative characteristics, the factors that influence preparers of statements to use creative accounting and creative accounting practices. The methodology used in this paper is established in the next section and then the results are analysed. The article concludes with recommendations regarding possible areas for future consideration.

2 Literature review and hypotheses
The literature forms the basis for the hypotheses development and discusses the Code and the qualitative characteristics identified in the Framework to establish the role that they play in safeguarding the integrity of financial statements. Preparers of financial statements’ incentives to misrepresent earnings are identified, as an awareness of their existence may influence auditors’ attitudes towards clients’ earnings manipulation attempts. Finally, earnings management practices are reviewed.

2.1 Ethical judgement
Velayutham (2003:483) explains that professions need a code of ethics to reassure the public and clients of their members’ responsibilities and thereby maintain members’ integrity and reputations. The Code identifies the objectives of the accountancy profession as working to the highest standards of professionalism, attaining the highest levels of performance and meeting its responsibility to the public. To achieve these objectives, members have to observe a number of fundamental principles: integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and compliance with technical standards.

Velayutham (2003) separates the principles in the Code into two categories: those principles that establish the character and moral responsibility of the members of the profession and those principles that establish the characteristics of professional behaviour and the requirement to comply with technical standards. Velayutham (2003:501) challenges the ability of the Code to establish the moral responsibility of the profession. Velayutham (2003) contends that the Code focuses primarily on the quality of the service provided by accountants and auditors and not on ethics. He suggests that the principles of professional behaviour and compliance with technical standards are not ethical principles, because their compliance depends on law-like statements and quality standards that do not allow for autonomous decision-making. In Velayutham’s (2003) opinion, only the principles that focus on character and moral responsibility are ethical principles. In addition, the requirement that auditors evaluate whether financial statements fairly present the underlying transactions and events in terms of statements of GAAP has shifted the focus of the Code from ethics to quality (Velayutham 2003).

Schlachter (1990) suggests that ethical judgement is a function of the Code and of the written and unwritten organisational policies that govern members’ contacts with colleagues, clients and third parties. Francis (1990), on the other hand, states that accountants’ own moral agency is involved in the production and creation of accounting reports. Elias (2002) investigates how members of the accounting profession view aggressive earnings behaviour and he concludes that highly idealistic members judge
earnings management more harshly than less idealistic members do. In this context, idealism is defined as an “individual’s attitudes towards the consequences of an action, and how these consequences affect the welfare of others”.

In summary, auditors’ ethical judgements are formed by the provisions of the Code, organisational policies governing ethics and individuals’ own moral agency. Ethical judgement is fundamental to auditors in forming an opinion as to whether financial statements fairly present the financial position, results of operations and cash flows of an entity and is distinct from compliance with statements of GAAP. Therefore it is proposed that:

H1: Auditors’ ethical judgements are associated with their attitudes towards earnings management.

2.2 Qualitative characteristics

The Collins Shorter English Dictionary (1995:939) defines quality as the “degree or standard of excellence, especially a high standard”. Smith (1993) proposes that quality be assessed against accepted standards of merit for such things (any item that is being evaluated for quality) and against the interests or needs of users and other stakeholders. Smith (1993) suggests that quality cannot be measured directly, as it is an abstract characteristic. Determining the quality of something may involve taking measurements of its many attributes; these measurements serve as a proxy for quality, but are not a measure of quality itself.

In the financial accounting context, the quality of financial statements is determined by applying the qualitative characteristics identified in the Framework. The attributes of quality (useful accounting information) identified in the Framework are understandability, relevance, reliability (consisting of faithful representation, neutrality and prudence) and comparability. Usefulness for decision-making is identified as the most important characteristic; utility to the user depends on the user’s ability to understand the financial information. Relevance and reliability are identified as the primary characteristics that make information itself useful and they interact with a secondary characteristic, namely comparability, to ensure usefulness. The Framework does not assign priorities to these qualities and suggests that there be a trade-off between relevance and reliability in order to achieve usefulness. For preparers of financial statements, these characteristics serve as guidelines in making choices: deciding on the nature of transactions, on the attribute that needs to be measured, on how to allocate costs between periods, on the level of aggregation or disaggregation of information and even on the captions to be used in the financial statements themselves (FASB 1980:6-11).

Auditors are expected to consider whether the information presented in the financial statements is relevant, reliable, comparable and understandable when they are forming an opinion on whether the financial statements fairly present the financial position, results of operations and cash flows of an entity (IAASB 2003). SAS 90 (AICPA 2000:11) requires external auditors to discuss their judgement about the quality, and not just the acceptability, of an entity’s accounting principles as applied in its financial statements with the audit committee. Specifically, the discussion should address items that have a significant impact on the representational faithfulness, verifiability and neutrality of the accounting information. Auditors in South Africa have been required to comply with International
Federation of Accountants (IFAC) pronouncements from January 2005. Previously, in South Africa, there was no requirement that auditors discuss the quality of an entity’s accounting principles with the audit committee.

The interpretation of the definitions of the qualitative characteristics and their relationship to each other appear to be evolving as financial reporting becomes more complicated. A review of recent literature reveals that there is a debate about the hierarchy between the qualitative characteristics (Mozes 1998; Schipper 2003), when faithful representation is achieved (Alexander & Archer 2003) and the role that conservatism (prudence) plays in the provision of timely information (Watts 2003).

To conclude, although the interpretation and application of the qualitative characteristics is still under debate ISA 700 (IAASB 2003) requires that they are considered when forming an opinion on whether financial statements fairly present the financial position, results of operations and cash flows of an entity, while SAS 90 requires the external auditor to report on their application to the internal audit committee. It is therefore proposed that

**H2:** Auditors’ evaluations of the quality of financial reporting practices, based on the qualitative characteristics in the conceptual framework, are associated with their attitudes towards earnings management.

### 2.3 Factors that influence the use of creative accounting practices

Table 1 summarises the factors identified in the literature that influence management to use earnings manipulation techniques (creative accounting). Broadly speaking, these are meeting forecasts and institutional investors’ expectations, not reporting reduced profits, maximising the directors’ remuneration, and taking advantage of weak company boards.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Author</th>
<th>Main finding</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Meeting targets</strong></td>
<td></td>
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<tr>
<td><strong>Analysts’ targets</strong></td>
<td>Abarbanell and Lehavy (2003)</td>
<td>Firms that receive “buy” recommendations from analysts are more likely to manage earnings to meet analysts’ earnings expectations.</td>
</tr>
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<td></td>
<td>Matsumoto (2002)</td>
<td>Firms manage earnings upwards and guide analysts’ forecasts downwards to avoid missing expectations at the earnings announcement date.</td>
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<tr>
<td><strong>Directors’ profit forecasts</strong></td>
<td>Kasznik (1999)</td>
<td>Managers use positive discretionary accruals to manage earnings upwards when earnings would otherwise fall below management’s earnings forecasts.</td>
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<td></td>
<td>Loomis (2001)</td>
<td>Directors create unreasonable expectations in investors when they announce unrealistic forecasts.</td>
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<td></td>
<td>Donnelly and Lynch (2002)</td>
<td>The market anticipates opportunistic manipulation when outside ownership is significant and diffuse.</td>
</tr>
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*continued*
Factor | Author | Main finding
---|---|---
**Debt covenants** | Defond and Jiambalvo (1994) | Firms accelerate earnings one year prior to debt violation.
 | Sweeney (1994) | Firms that violate covenants make income-increasing accounting changes but these typically take place after the violation, i.e., firms do not make accounting changes specifically to avoid violating debt covenants.
 | Healy and Wahlen (1999) | Firms make changes in accounting policies and estimates in response to financial difficulties.
**Avoid reporting losses and decreases in profits** | Barth, Elliot and Finn (1999) | Firms with a consistent pattern of earnings increases command higher price-to-earnings multiples and this premium is larger for longer series of earnings increases and the premium is reduced substantially when the established pattern of earnings is broken.
**Management remuneration** | Watts and Zimmerman (1979) | Agency costs arise because managers’ interests do not coincide with interests of shareholders and bondholders.
 | Ittner, Larcker and Rajan (1997) | Financial statements become the focal point of managers’ wealth maximisation strategy when bonus plans and stock options are based on accounting results.
**Share repurchases** | DeAngelo (1986) | There is no evidence that managers systematically understate earnings in periods before management buyouts.
 | Vafeas, Vlitis Katranis and Ockree (2003) | There is weak evidence that management uses creative accounting to reduce earnings prior to a firm’s repurchasing its shares.
**Company boards** | Beasley, Carcello, Hermanson and Lapides (2000) | Non-fraud companies have a higher percentage of outside directors on their boards and generally have audit committees whose members are independent.
 | Imhoff (2003) | Board members’ independence is impaired when members are paid with share options. Creative accounting is more prevalent in firms where the CEO influences the nomination and agenda of company boards.

This report pre-supposes that South African auditors are more likely to reject earnings manipulation attempts in entities that display the above characteristics. **?? point unclear** It may be assumed that auditors are likely to be especially cautious in evaluating the acceptability of management’s earnings management attempts in entities displaying the above characteristics.

This research will establish whether:
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H3 Auditors’ attitudes toward earnings manipulation are associated with their perceptions of management’s incentives to use earnings manipulation.

2.4 Earnings management practices

“Preparers of financial statements who engage in creative accounting exploit loopholes in the rules in order to present a deliberately misleading (normally, flattering) impression…” (Alexander & Archer 2003:12). This quotation implies that earnings management can take place within the principles and practices established in GAAP. Nelson, Elliot and Tarpley (2003:17) suggest that earnings management can be classified as consistent with and difficult to distinguish from GAAP or clearly not GAAP, that is a deliberate violation of principles. Within GAAP manipulation can be achieved by structuring transactions to meet the requirements for particular accounting treatments, even if such treatments do not reflect the true economic substance of the transaction (Maines et al. 2003:74); or by taking advantage of the requirements for exercising judgement, making estimates and forecasting inherent in implementing reporting standards (Schipper & Vincent 2003:104).

Nelson et al. (2002:180) state that “when accounting rules use precise guidance to distinguish between alternative accounting treatments and/or to tie accounting recognition to the occurrence of specific events, we predict managers will structure transactions to meet precise guidance”. Nelson et al. (2002:180) classify the timing of transactions as structuring events. They cite the example of selling “available for sale” financial assets, when it is not economically sound to do so, in order to boost disappointing profits with deferred gains that are transferred to income in terms of IAS 39 (IASB: 2000). Nelson et al. (2003) and Schilit (1993) advise that cut-off dates and the delayed or accelerated shipping of goods can be abused to influence reported earnings.

The application of accrual accounting requires preparers of financial statements to exercise professional judgement to allocate revenue and expenditure to the relevant accounting periods; management can use this process to achieve earnings management. Young (1999) suggests that accruals are the preferred method for manipulating financial information, because they are difficult to observe directly. Management can manipulate the timing of the recognition of a transaction. So, for example, the timing of the recognition of liabilities can be delayed by deliberately misjudging the existence of a present or constructive obligation (Elliot & Hanna 1996). Schilit (1993) provides examples where revenue is recognised when important uncertainties exist or services are still to be rendered.

Measurement is intrinsic to the accrual process and can be abused whenever an amount is recognised in the financial statements, as GAAP requires that preparers of financial statements use assumptions about the future to estimate cash flows. Nelson et al. (2003) provide examples of recognising too much or too little in respect of loan losses and asset impairment. Beasley et al. (2000) found that in the services industry loans receivable are overstated, and in the technology and health industries inventories and accounts receivable are overstated. Clikeman (2003) suggests that managers can influence reported expenses by accruing larger or smaller liabilities for warranties, environmental clean-up costs and restructuring costs; assumptions and expected returns can be manipulated to bias the assumed rate of return on pension fund plan assets and the expected level of benefits on pension plan liabilities. Hillier and McCrae (1998) and Nelson et al. (2003) provide evidence that depreciation is used to either increase or decrease profits by manipulating the expected lives of assets and their ultimate realisable values.
The above literature review suggests that aggressive accounting can occur by structuring transactions to avoid recognition criteria within GAAP, or by manipulating recognition and measurement criteria to achieve a predetermined result.

Auditors’ attitudes towards creative accounting techniques were assessed by presenting a sample with scenarios based on the creative accounting practices identified in the above literature review. A seven-point scale was used to assess whether auditors agreed or disagreed with management’s accounting choices.

3 Methodology

This study will establish whether

H1: Auditors’ ethical judgements are associated with their attitudes towards earnings management.

H2: Auditors’ evaluations of the quality of financial reporting practices, based on the qualitative characteristics in the conceptual framework, are associated with their attitudes towards earnings management.

H3: Auditors’ attitudes toward earnings manipulation are associated with their perceptions of management’s incentives to use earnings manipulation.

3.1 Sample

A questionnaire was distributed to the audit partners and senior managers at the “big four” auditing firms and three medium sized firms. Approximately 600 questionnaires were distributed (according to feedback from the partners concerned) and 40 replies were received, which is a response rate of 6.33%.

Nelson et al. (2002) report the results of a questionnaire distributed to partners and managers of a Big 5 firm in 1998. That questionnaire required participants to identify specific earnings management attempts experienced with clients and whether participants, that is the auditors, decided to prevent such attempts by requiring adjustments to the financial statements. Nelson et al. (2002 report a final response rate of 16% (20% for partners and 14% for managers of the population surveyed). They attribute this rate to the fact that auditors are sensitive about earnings management, the fact that partners may not have distributed surveys to managers or did not encourage managers to respond, and the fact that the survey instrument was lengthy, requiring about 30 to 45 minutes to complete.

In this study, an attempt was made to manage auditors’ sensitivity to creative accounting; confidentiality and anonymity were assured, as replies were submitted to a web administrator who accessed the completed questionnaires and forwarded these to the researcher, who was therefore unable to identify the respondents. Participants were also encouraged to fill in the questionnaire. The introduction to the research instrument stressed that there were no correct or incorrect answers. However, this study was conducted in 2004, after the Enron and WorldCom scandals, in an environment where auditors were being severely criticised for failing to issue qualified audit reports where GAAP principles were violated and financial statements did not fairly present underlying transactions. It is therefore possible that auditors’ reluctance to respond to questions about creative accounting issues may have increased since 1998.
In this study, permission was obtained to distribute questionnaires to audit partners and senior managers from one of the partners in the technical department of the firm. The partner was sent the questionnaire and it was left to that partner to distribute the questionnaire electronically to all the partners and senior managers in the firm. However, this study suffers from the same constraint identified by Nelson et al. (2002), as there is no way of identifying whether the questionnaires were in fact distributed or whether the distributing partner encouraged potential participants to complete the questionnaire.

The research instrument in this survey was somewhat less complicated than that used by Nelson et al. (2002) as participants were asked to respond to set earnings management attempts, where the Nelson et al. (2002) survey required that earnings management attempts first be described and then asked respondents to describe whether they required a restatement of the financial statements. The questionnaire distributed by this researcher would have taken approximately 30 minutes to complete; some of the targeted population may have declined to participate because of the survey length.

In this study, 57% of the responses received were from partners and 43% of the responses received were from managers. Nelson et al. (2002) report a response rate of 20% for partners and 14% for managers of the population surveyed. This may indicate that partners in South Africa are more interested in creative accounting than senior managers or than their counterparts in America, or that audit partners have more experience with restatement decisions than audit seniors. However, because of the limited response rate, this is a matter that would have to be investigated further.

In this survey, the mean experience of participants, after attaining their professional qualification, was 14.52 years; the standard deviation was 11.33 years. This compares favourably with the average experience of 14.1 years reported by Nelson et al. (2002). In view of the experience of the respondents it was decided to include an additional hypothesis, namely:

\[ H4: \text{the more experienced an auditor is, the less likely it is that s/he will agree with management's creative accounting choices.} \]

### 3.2 Research model

The relationship between auditors’ attitudes towards creative accounting, their ethical orientation, their evaluation of the quality of financial reporting and their perceptions of the factors that influence preparers of financial statements to use earnings management techniques (see Figure 1) was tested using the partial least squares approach (PLS) to structural equation modelling (see Falk & Miller 1992). As this research is exploratory in nature, PLS is preferred to a confirmatory approach such as LISREL (Linear Structural Relations) (Barclay, Higgins & Thompson 1995). PLS allows the researcher to construct unobservable latent variables and to model the relationships between them. In addition, it is particularly useful for analysing small samples (Chin 1998).
In the above model auditors’ ethical judgment, assessment of the quality of financial reporting, perceptions of the factors that have an impact on the use of creative accounting are unobserved or latent or exogenous constructs (independent variables) that are hypothesised as some of the factors that explain auditors’ attitudes towards creative accounting – the endogenous (dependent variable).

Fornell and Bookstein (1982) explain that unobserved latent constructs can be viewed as underlying factors or as indices that are produced by or reflect the observed indicators. The observed indicators can therefore be treated as either formative or reflective. Barclay et al. (1995:292) state that ‘a construct with reflective indicators is one where the observed variables are expressed as a function of the construct – the variables reflect or are manifestations of the construct’. On the other hand, ‘a construct with formative indicators implies that the construct is expressed as a function of the variables; the variables ‘form’, cause or precede the construct’. In the above model, the three dimensions of auditors’ evaluation of the quality of financial reporting practices (understandability, relevance and reliability) are modelled in the formative mode. This is considered to be appropriate as auditors’ assessment of the quality of reporting contained in the scenarios form the quality of reporting construct. The rest of the exogenous and endogenous constructs are modelled in the reflective mode. Auditors’ attitudes towards creative accounting will influence their acceptance of creative accounting techniques; similarly, auditors’ ethical orientation will
affect their ethical judgements and auditors’ experience of the internal and external factors that induce creative accounting will influence their perceptions of the significance of these factors in the use of earnings manipulation techniques.

**Construct measurement**

**Ethical judgement**

Ethical judgement was measured using some of the vignettes used by Douglas, Davidson and Schwartz (2001) to establish measures of ethical judgment. (Permission was obtained to use these vignettes.) The scenarios used to measure this construct are detailed in Appendix A. An analysis of the vignettes used reveals that they are all based on principles of professional behaviour focusing on character, which are the ethical principles identified by Velayutham (2003). This was considered to be appropriate, as auditors’ assessment of the quality of financial reporting was assessed using a separate construct.

**Quality of financial reporting**

Preparers of financial statements’ understanding of the role that the qualitative characteristics play in the provision of useful (quality) financial information is based on the approach taken by McDaniel, Martin and Maines (2002). Members of audit committees were asked to assess the quality of reporting treatment of six specified financial statement items in respect of the components of relevance and reliability. This study used scenarios that involve creative accounting techniques and asked the respondents to evaluate the quality of the accounting treatment, represented by relevance, understandability and reliability. Reliability consisted of auditors’ evaluation of the representational faithfulness, neutrality and prudent measurement applied by preparers of financial statements in the given scenarios. The scenarios used to measure this construct are listed in Appendix A.

**Perceptions of factors that influence preparers to use creative accounting techniques**

A seven-point scale was used to measure whether auditors agreed that the factors identified in the literature review influence preparers of financial statements to use creative accounting techniques. The questions posed are included in Appendix A.

**Attitude towards creative accounting**

The auditors’ attitudes towards creative accounting construct was measured by asking respondents to indicate whether they agree or disagree (based on a seven-point Likert scale) with preparers of financial statements’ creative accounting attempts. The scenarios used were based on earnings management attempts, as identified in Section 2.4 of the literature review.

### 4 Empirical results

#### 4.1 Measurement model

**4.1.1 Validity and reliability**

Principal components factor analysis (PCA) was used to confirm the construct validity of the multivariate measures representing the exogenous constructs (the independent variables). Details of the multivariate measures are presented in Appendix A.
Ethical Judgment

Item X2 was excluded, as the content validity of the item was questionable, and it was considered prudent to exclude it. Item X5 was excluded, as it failed to correlate more than 0.300 with any of the other ethical items. PCA was then applied to Items X1, X3, X4 and X6; Item X1 was excluded, as it did not load onto the same factor as Items X3, X4 and X6. Items X3, X4 and X6 were aggregated to produce a single ethics score, which became the manifest variable in the model’s analysis. The average variance extracted (AVE) was 66.7%, which means that the indicators are representative of the construct and that the construct explains 66.7% of the variance in the observed measures. The Cronbach alpha score calculated was 0.74. The Cronbach alpha score tests reliability and that the individual indicators of a construct are correlated highly enough with each other to be assured that they are measuring the same construct. Hair, Anderson, Tatham and Black (1998:80) suggest that, to test for reliability, the Cronbach alpha score should be above 0.6.

The respondents’ ethical judgement thus consisted of decreasing fees to attract new clients, warning a client of a debtor’s bankruptcy, where the debtor is also a client of the same auditor, and employing a relative of an existing client. Theoretically, it makes sense that these scenarios are measuring the ethical construct, as they all represent violations of the Code. Lowering fees to attract new clients is prohibited in Sec 12.12. Members are obliged to respect clients’ confidentiality in Sec 5.01. Employing a relative of a client may impinge on the independence requirements in Sec 11 of the Code. The scenarios excluded, that is, breaking the confidence of a client’s employees, taking a client to lunch in appreciation of an introduction to a potential client and accepting an audit where the partner was involved in previous fundraising activities are not direct contraventions of the requirements of the Code.

Auditors’ perceptions of the factors that influence the use of creative accounting

Correlation analysis indicated that Items W13 and W10 (high growth firms) should be dropped as they do not correlate more than 0.300 with the other “influence” items. Logically, auditors’ evaluation of the nomination of board members by top management, as a factor that influences preparers of financial statements to use creative accounting techniques, should have correlated with the other scenarios assessing a lack of corporate governance. Top management’s nomination of directors may be a less important component of good corporate governance than outside director representation and the existence of audit committees. Managers of high growth firms can rationally be expected to be under pressure from analysts and investors to maintain earnings trends. Nevertheless, auditors do not appear to regard this incentive to be in the same category as the other incentives to meet targets, which are to exceed or meet analysts’ profit expectations and executives’ earnings forecasts, to avoid reporting a loss, or slow down in growth and to prevent a violation of debt covenants (Items W1, W2, W6 and W7). The PCA produced a multi-factor solution. Earnings management prior to a firm’s repurchasing its own shares (Item W3) and high institutional ownership as an incentive to use earnings management (Item W8) were excluded, as they failed to load high on any factor.

The literature review revealed weak evidence that management uses creative accounting to reduce earnings prior to a firm’s repurchasing its shares (DeAngelo 1986; Vafeas et al. 2003). The respondents to this survey did not appear to consider the influence of institutional investors to be an incentive to using earnings manipulation in the South African environment. This contrasts with the conclusions reached by Matsumoto (2002) and Donnelly and Lynch (2002) that firms with high transient institutional ownership are
more likely to take action to meet or exceed analysts’ forecasts and that the market anticipates opportunistic manipulation when outside ownership is significant and diffuse. Item W9, firms with a constant pattern of losses are not likely to manage earnings upwards, was excluded, as it loaded as its own factor following an oblique rotation. It seems reasonable to exclude this variable, as firms making losses would be judged differently from profitable firms. A stable three-factor solution then emerged, with an AVE of 75.5%. The three dimensions identified were the following:

**Management remuneration:**
Managers who are entitled to bonuses based on earnings and who hold share options have an incentive to increase reported profits (Items W4 and W5). The Cronbach alpha score calculated was 0.84. The two items were aggregated to form a mean score.

**Meeting targets**
Managers engage in creative accounting practices in order to exceed or meet analysts’ profit expectations and executives’ earnings forecasts, to avoid reporting a loss or slow down in growth and to prevent violation of debt covenants (Items W1, W2, W6 and W7). The Cronbach alpha score was calculated as 0.75. These four items were aggregated to form a mean score.

**Corporate governance:**
The existence of audit committees and their composition were deterrents to management profit manipulation (Items W11 and W12). The Cronbach alpha calculated was 0.73. These two items were aggregated to form a mean score. The management remuneration, meeting targets and corporate governance scores were then modelled as the manifest indicators of the influence construct.

**Attitude towards creative accounting**
Item Z3 was excluded from the factor analysis, as it had only been included in the questionnaire as a control indicator.

PCA revealed that two factors emerged, factor 1 consisting of Items Z1, Z2, Z4, Z5 and the second factor (Items Z6, Z7 and Z8). The items of the second factor, however, did not correlate sufficiently with one another; the factor was considered unreliable and was therefore excluded. Only the first factor was retained, with an AVE of 50.2%, which is close enough to the generally accepted norm of 0.55 (Falk & Miller 1992) to be retained. The Cronbach alpha calculated was 0.65. The four items were aggregated to produce a single attitude score, which was modelled as the indicator of the attitude construct. The mean of the single attribute score was 1.6, which suggests that the respondents largely rejected creative accounting attempts.

**Table 2 Descriptive statistics (reflective constructs only)**

<table>
<thead>
<tr>
<th>Construct and indicators</th>
<th>No of items</th>
<th>Mean</th>
<th>Standard deviation</th>
<th>Cronbach alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethical judgment</td>
<td>3</td>
<td>2.65</td>
<td>1.13</td>
<td>.74</td>
</tr>
<tr>
<td>Influences</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management remuneration</td>
<td>2</td>
<td>2.69</td>
<td>1.18</td>
<td>.84</td>
</tr>
<tr>
<td>Meeting targets</td>
<td>4</td>
<td>3.70</td>
<td>1.13</td>
<td>.75</td>
</tr>
<tr>
<td>Corporate governance</td>
<td>2</td>
<td>4.09</td>
<td>1.33</td>
<td>.73</td>
</tr>
<tr>
<td>Attitude</td>
<td>4</td>
<td>1.598</td>
<td>.556</td>
<td>.65</td>
</tr>
</tbody>
</table>
Quality of financial reporting

Because the three dimensions (relevance, reliability and understandability) making up this construct were modelled in the formative mode, an initial PCA was unnecessary. The items were not required to correlate highly with one another. The scenarios reflected six different creative accounting attempts which were not necessarily equally misleading or readily identifiable as creative accounting attempts. When a construct is modelled in the formative mode, each manifest variable contributes variance to the latent variable, but there need not be common variance among the manifest variables themselves. Answers to the six scenarios were modelled as the manifest formative indicators of the Y construct and the aggregates for relevance, reliability and understandability were modelled as the formative indicators for the construct. The construct was modelled as a linear combination of the indicators, in other words, the indicators formed the construct. The indicators of this construct consisted of understandability, relevance and reliability. As Figure 2 shows, it was decided to model quality of financial reporting as the second order construct of the three first order constructs of relevance, reliability and understandability. Paths from the first order constructs to the second order construct were understandability (0.238), relevance (0.411) and reliability (0.391).

Figure 2 PLS Model (The broken lines represent the measurement model; the solid lines represent the structural model.)

Management remuneration Item W4 managers and board members holding share options, Item W5 managers’ bonuses based on profits.

Meeting targets Item W1 meet analysts’ profit expectations, Item W2 meet directors’ earnings forecasts, Item W6 avoid reporting a loss or a slow down in growth, Item W7 existence of debt covenants.

Corporate governance Item W11 absence of audit committee, Item W12 poor outside director representation
Determinants of auditors’ attitudes towards creative accounting

Item X3 decreasing fees to attract new clients, Item X4 warning a client of a debtor’s bankruptcy, Item X6 employing relative of an existing client.

**Quality of financial reporting Items** Y1 to Y6 represent the scenarios used to assess auditors’ evaluation of the quality of accounting treatment.

**Attitudes towards creative accounting Item** Z1 overstatement of pension liability, Item Z2 sale and leaseback structured as operating lease, Item Z4 SPE not consolidated, Item Z5 controlled subsidiary not consolidated.

### 4.2 Structural model

The path coefficients used to assess the structural table are presented in Table 3 and the solid lines in Figure 2.

The overall fit of the structural model is evaluated by $R^2$ on the endogenous latent construct. The size of the $R^2$ on the endogenous constructs indicates the predictive power of the structural model. The $R^2$ represents the variance accounted for or explained by the independent constructs and should be at least 0.10 (Falk & Miller 1992) in order to ensure that the interpretation of the path coefficients is meaningful. The model used in this study explains 34.7% of the variance in auditors’ attitudes towards creative accounting and is thus considered adequate.

<table>
<thead>
<tr>
<th>Relationship</th>
<th>Hypothesis</th>
<th>Expected sign</th>
<th>Path coefficient</th>
<th>t value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ethical judgment</td>
<td>H1</td>
<td>+</td>
<td>.012</td>
<td>0.0898</td>
</tr>
<tr>
<td>Quality</td>
<td>H2</td>
<td>+</td>
<td>.417</td>
<td>3.1690**</td>
</tr>
<tr>
<td>Influences</td>
<td>H3</td>
<td>+</td>
<td>.017</td>
<td>0.1030</td>
</tr>
<tr>
<td>Experience</td>
<td>H4</td>
<td>-</td>
<td>-.390</td>
<td>2.9296**</td>
</tr>
</tbody>
</table>

** p<0.01

### 5 Discussion

The purpose of this paper was to investigate whether auditors’ attitudes towards creative accounting are influenced by their evaluation of the quality of financial reporting, their perceptions of factors that influence preparers of financial statements to use aggressive accounting techniques and their own ethical judgment. This study was exploratory, as the relationship between the constructs was speculative. The research model indicated that only H2, that auditors’ evaluation of the quality of financial reporting practices influences their attitude towards creative accounting practices, can be supported. Hypothesis 1 and 3, that auditors’ attitudes towards creative accounting are influenced by their ethical judgement and that their perceptions of management’s incentives to use creative accounting, are not supported.

This research provides insights into the attitudes of auditors’ when they assess creative accounting practices. Firstly, this finding seems to support the contention of Velayutham (2003) that quality assurance has come to be regraded as paramount and that the ethical principles section of the Code has little impact on professional practice.

Secondly, the research identifies that relevance and reliability are more important than understandability in assessing the quality of financial information. This finding is
somewhat surprising, as the Framework ranks understandability equal to relevance and reliability as the principal qualitative characteristics that make the information provided in financial statements useful to users.

Thirdly, the findings of this study indicate that auditors perceive that meeting analysts and management targets, the maximization of remuneration and a lack of corporate governance are factors that influence the use of aggressive accounting by management. However, auditors’ attitudes towards creative accounting are not associated with the existence of these factors.

Lastly, the research model has identified a negative relationship between experience and auditors’ attitudes towards creative accounting, indicating that the more experienced an auditor is, the less likely it is that s/he will agree with management’s creative accounting choices.

6 Limitations, conclusion and areas for future research

6.1 Limitations
The low number of respondents makes it difficult to test the measurement model; therefore the relationships between the constructs and their manifest variables could not be fully explored.

There is some overlap between the scenarios used to test the qualitative characteristics and auditors’ assessment of earnings management techniques, as both sets of scenarios are based on creative accounting techniques. However, the fact that the Cronbach alpha scores were over 0.60 indicates that attitudes towards creative accounting and assessments of reliability and relevance can be measured.

This study is based solely on participants’ responses to given scenarios and there is a risk that the respondents may not have answered the questionnaire honestly. Flory et al. (1992:295) point out limitations to this type of research. It is possible that an individual’s ethical response to an observed happening might not totally predict the person’s willingness to behave in the same way in practice, and that there is a concern that the ego-involving character of the responses would produce a socially desirable response bias. Gibson and Frakes (1997:170) warn that self-reported unethical behaviour may be understated, due to the social desirability bias against reporting unethical behaviour.

6.2 Conclusion
The ability of the accountancy profession to provide truthful financial information that is essential to the functioning of capital markets was evaluated. The quality of financial information is based on the qualitative characteristics identified in the conceptual framework and standards of GAAP. This study tested the relationship between ethical judgement, the evaluation of the quality of financial reporting and auditors’ attitudes towards creative accounting and found that ethical judgement does not influence attitudes towards creative accounting, but that the assessment of the quality of information does explain some auditors’ attitudes. In addition, it was found that the understandability of information was not as important as relevance and reliability in ensuring the quality of information.
Auditors are expected to consider whether the information presented in the financial statements is relevant, reliable, comparable and understandable when forming an opinion on whether financial statements fairly present the financial position, results of operations and cash flows of an entity and are required to discuss their judgement about the quality of an entity’s financial statements with the audit committee. It is suggested that this quality assessment will enhance the usefulness of financial information for all users and should therefore be included the statutory auditor’s report.

6.3 Areas for future research
These findings indicate several areas for further research. One important area is an evaluation of the effectiveness of the Code of Professional Conduct in constraining creative accounting. This could entail an evaluation of the provisions of the Code itself, the teaching of the Code at the tertiary level and the development of professional ethics after achieving the required professional qualifications. The findings of this report suggest that the more experienced members of the profession should be involved in this project. Secondly, auditors’ evaluation of the understandability of financial statements and the presentation and disclosure of information should be investigated to identify why understandability features less prominently than relevance and reliability in auditors’ evaluations of the quality of financial statements. Lastly, the qualitative characteristics assume an important role in auditors’ assessment of the quality of accounting principles used in the preparation of financial statements; therefore, their definition and the interaction between relevance and reliability could be part of the IASB’s project to revise the principles contained in the Framework.

Bibliography


Determinants of auditors’ attitudes towards creative accounting


Appendix A: Constructs and measures

<table>
<thead>
<tr>
<th>Factors that influence the use of creative accounting practices</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>W1 Meet analysts' profit expectations</td>
<td></td>
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<tr>
<td>W2 Meet directors' earnings forecasts</td>
<td></td>
</tr>
<tr>
<td>W3 Firm repurchasing own shares</td>
<td></td>
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<tr>
<td>W4 Managers and board members' holding share options</td>
<td></td>
</tr>
<tr>
<td>W5 Managers' bonuses based on profits</td>
<td></td>
</tr>
<tr>
<td>W6 Avoid reporting a loss or slowdown in growth</td>
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<tr>
<td>W7 Existence of debt covenants</td>
<td></td>
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<tr>
<td>W8 High institutional ownership</td>
<td></td>
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<tr>
<td>W9 Firms constantly making losses are not likely to manage earnings upwards</td>
<td></td>
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<tr>
<td>W10 High growth firms</td>
<td></td>
</tr>
<tr>
<td>W11 Absence of audit committee</td>
<td></td>
</tr>
<tr>
<td>W12 Poor outside director representation</td>
<td></td>
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<tr>
<td>W13 Board of directors nominated by top management</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ethical judgements</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>X1 Breaking confidence of client’s employees</td>
<td></td>
</tr>
<tr>
<td>X2 Taking client to lunch in appreciation of introduction</td>
<td></td>
</tr>
<tr>
<td>X3 Decreasing fees to attract new clients</td>
<td></td>
</tr>
<tr>
<td>X4 Warning client of a debtor’s bankruptcy</td>
<td></td>
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<tr>
<td>X5 Accepting an audit where auditor had been involved in previous fundraising</td>
<td></td>
</tr>
<tr>
<td>X6 Employing relative of an existing client</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quality of financial reporting</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Y1 First time recognition of environmental liability debited to accumulated profit</td>
<td></td>
</tr>
<tr>
<td>Y2 Provision for warranty costs not recognised</td>
<td></td>
</tr>
<tr>
<td>Y3 Impairment loss on asset not recognised</td>
<td></td>
</tr>
<tr>
<td>Y4 Restructuring provision incorrectly recognised as a liability at acquisition date</td>
<td></td>
</tr>
<tr>
<td>Y5 Revenue recognised before installation completed</td>
<td></td>
</tr>
<tr>
<td>Y6 Employee share trust not consolidated</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Attitude towards creative accounting</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Z1 Overstatement of post retirement benefit liability to reduce earnings</td>
<td></td>
</tr>
<tr>
<td>Z2 Sale and leaseback structured as an operating sale and leaseback risks and rewards of ownership remain with seller</td>
<td></td>
</tr>
<tr>
<td>Z3 Recognition of profit on forward exchange agreement</td>
<td></td>
</tr>
<tr>
<td>Z4 Revised likelihood of recovering an assessed loss from unlikely to probable when underlying circumstances had not changed</td>
<td></td>
</tr>
<tr>
<td>Z5 SPE not consolidated</td>
<td></td>
</tr>
<tr>
<td>Z6 Controlled subsidiary not consolidated</td>
<td></td>
</tr>
<tr>
<td>Z7 Revenue recognised when goods dispatched to an agent</td>
<td></td>
</tr>
<tr>
<td>Z8 Timing of delivery of goods delayed to next financial year</td>
<td></td>
</tr>
</tbody>
</table>