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Article

The Negative Effects of Creative Accounting Threaten Investment Opportunities for Shareholders in Commercial Banking Institutions

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Abstract: In this artical, the sustainability and profitability of commercial banks will be assessed against the backdrop of their importance in ensuring the integrity of international economic structures. Due to their indispensable role in achieving global economic growth, financial institutions might sometimes resort to the use of advanced accounting skills to prepare financial statements that tend to exaggerate their financial results. This practice is intended to provide a distorted view of the actual financial standing of the institutions concerned and cause investors to lose sight of their investment goals. In this paper, the use of financial manipulation by financial institutions in relation to their capital adequacy ratio, provision for loan losses, and non-performing loans ratio will be studied to find out how such financial manipulation distorts financial standing and reduces shareholders' value.

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1. Introduction

Creative accounting refers to the abuse of flexibility in accounting methods or gaps in the regulation of financial statements to show a better picture of the performance or position of the firm compared to what is actually the case. However, it should be noted that although these practices might not be necessarily illegal, they usually lead to ambiguity between manipulation and fraud. While trust, capital adequacy, and solvency are fundamental concepts in the banking industry, the significance of creative accounting becomes even more critical. While some industries might rely on leverage in carrying out their businesses, the banking industry depends on trust for sustaining its liquidity. In the event of using creative accounting to mask the underlying risks, shareholders stand to lose significantly due to decreased share prices, regulatory sanctions, and financial crises in severe instances. This article seeks to describe some of the most common forms of creative accounting in financial institutions, discuss the mechanisms by which such accounting practices affect shareholder wealth, and use case studies to illustrate the aforementioned adverse implications, as discussed in previous literature.

The issue that this particular study aims to address relates to the results of the study of concern, specifically the difference between the actual financial performance of commercial banks and the financial performance as reported. This difference arises from the adoption of creative accounting practices by certain departments within the banking industry, resulting in a misrepresentation of the true financial performance to investors. Although this practice may result in a positive increase in the value of shares, it also poses a future risk that may result in significant wealth loss for shareholders if detected. Therefore, the issue may be defined through the following research questions:

1. To what extent does creative accounting in commercial banks affect shareholder wealth?
2. To what extent does creative accounting in commercial banks result in the achievement of sustainable intrinsic value, or does it merely result in temporary profits and significance?
3. What type of association does the misrepresentation of financial performance and the level of confidence in commercial banks have?

The Significance of the Study

This study aims to enlighten individuals on the concept of creative accounting in the banking sector, which is considered an extremely significant sector that influences the economy. The significance of the study is attributed to the following aspects:

1. Scientific significance: It recognizes an issue of concern in today's world—creative accounting in banking.
2. Practical significance: It assists investors in understanding the risks that lie in the financial statements that are ultimately disclosed.
3. Relevance to the banking sector: It encourages bank management to understand the importance of transparency in order to avoid any loss of trust.
4. Regulatory and supervisory relevance: It assists regulatory bodies in formulating strategies that will minimize accounting manipulation.
5. Economic significance: The stability of commercial banks is linked with economic stability.

Research Objectives

The objectives of the research are:

1. To shed more light on the practical implications of creative accounting in its theoretical context.
2. To elucidate the process through which the above practices impact the shareholders' wealth.
3. To assess the sustainability of profits generated through the use of creative accounting.
4. To investigate the relationship between transparency and investor confidence.
5. To identify the strengths, weaknesses, and gaps in the existing literature.

2. Research Methodology

This study develops its methodology as a qualitative analysis by utilizing an article review design in exploring the detrimental influences of creative accounting towards the wealth of shareholders in commercial banking institutions. This work is based on secondary data from various academic sources such as peer-reviewed journal articles, previous empirical works, regulatory reports and relevant theoretical literature on creative accounting practices, financial manipulation and performance in banking. The collection of data includes a systematic review of the existing literature to identify the common creative accounting techniques like earnings management, income smoothing, and off-balance-sheet financing, and their impact on financial reporting quality and the decision-making of investors. Additionally, several case studies – including historical financial crises and corporate scandals – are also integrated with real-world information regarding the ways such practices influence financial statements and other stakeholders. Prior to that, the research looks into important metrics around capital adequacy ratios, provisions for loan losses, and NPL ratios and how this manipulation transpires in bank operations. The methodological process for analysis involved a critical content analysis which identifies patterns, relationships, and inconsistencies in the literature, particularly in disparity between reported and actual financial performance. The study also takes a comparative approach by identifying the strengths and limitations of existing research and establishing gaps in the methodology and areas for future work. This methodology facilitates a holistic comprehension concerning the manner in which creative accounting erodes transparency and undermines investor confidence, besides jeopardizing shareholder value in driving the sustainability of the banking industry.

3. Results and Discussion

Theoretical Framework

3.1 The Concept of Creative Accounting:

The concept of creative accounting can be defined as innovative and complex accounting practices in which the accountant utilizes their understanding of accounting laws and methodologies to manipulate or alter the financial information in the records of an economic entity to attain specific goals [1]. It can also be defined as a series of actions taken by the management of an economic entity that significantly influences the financial results of that entity by hiding some of the economic or accounting realities, which might have a detrimental effect on the entity in the long run [2]. Moreover, the concept of creative accounting can also be defined as the unorthodox use of accounting policies and alternatives to attain specific goals, such as increasing profits or reducing losses, without violating any of the accounting standards. Some of the most significant accounting techniques in this domain include earnings management, income smoothing, and off-balance-sheet financing, which can be used to attain the desired financial results by using loopholes in accounting standards [3].

Consequently, the concept of creative accounting can be defined as accounting practices in which financial figures are altered, which are within the boundaries of accounting laws, though such accounting practices are significantly divergent from generally accepted accounting principles.

3.2 Characteristics of creative accounting:

Creative accounting is marked by certain distinct features, which are outlined by Murad [4] as follows:

1. Creative accounting represents an act of manipulation and deception in the areas of accounting, taxation, and auditing.
2. The implementation of creative accounting represents a systematic process undertaken with an objective in mind.
3. The rationale for the implementation of creative accounting is to attain a predetermined net profit amount in favor of the interests of the management of an economic entity.
4. Creative accounting is practiced within an environment of selection of accounting principles, standards, and regulations. Therefore, these legal accounting practices are undertaken by an accountant with advanced professional competence with the objective of manipulating, changing, and adapting the values in accordance with their own desires.
5. The continuous implementation of creative accounting in an economic entity leads to an erosion of user confidence in accounting information.
6. The environment of creative accounting is marked by certain characteristics of fraud, deception, misrepresentation, accounting malpractices, and an overall erosion of confidence in accounting practices.

3.3 Motivations for Engaging in Creative Accounting Practices

The motivations for using creative accounting practices by the administration of an economic entity include [5]:

1. To improve the entity’s reputation in the market with the aim of improving various financial indicators of the entity’s performance. This is particularly common in economically distressed entities, in which the entity’s financial situation or investment environment is such that it adversely affects the natural growth of the entity, thus leading to the use of creative accounting techniques.
2. To raise or maintain financing and improve the entity’s borrowing from financial institutions, which significantly affects the entity’s credit rating.
3. To improve the entity’s tax obligations by reducing profits and increasing expenses, thus reducing the amount of tax due to the government.
4. To improve the market price of the entity’s shares with the aim of maximizing the financial value of the entity.
5. To improve the financial performance of the entity in pursuit of personal interests, which may affect the decisions of the management of the entity, thus creating a positive image for the board of directors.

3.4 Detrimental Effects on Investment Initiatives within the Economic Unit

The detrimental effects of the adverse impacts on investment initiatives can be defined in terms of a sequential chain of effects [6].

Stage 1: Manipulation of Financial Reporting

Generation of inaccurate financial data

Stage 2: Misleading Investors

-Adoption of misguided investment choices

Stage 3: Inefficient Resource Allocation

-Support for weak or high-risk initiatives

Stage 4: Project Failure

-Realization of diminished returns or financial losses

Stage 5: Erosion of Trust

-Investor withdrawal

3.5 They increased in investment projects

On the other hand, the market valuation of the common stock of the economic entity depends on the expected returns that are available to the shareholders for the achievement of long-term objectives, as opposed to short-term objectives. According to Shodiya, et al., this wealth may be defined as “the present value of expected future cash flows available to the proprietors of the economic entity, i.e., the shareholders, and this wealth may be realized as periodic dividends or sale of shares.” [7] In addition, Sulimany, et al. have extended this definition of wealth by asserting that “the wealth of the shareholders…is the value transferred to shareholders in relation to the enterprise as a result of all investment and operational activities, and it is quantified via profits, share prices, and dividends. [8]”

On the other hand, the wealth of the shareholders may also be defined as the present value of the common stock of the economic entity. The proposition that will be presented herein asserts that the wealth of the shareholders may be defined as the value of the common shares of the entity, along with the profits that are realized by the shareholders, as this may be considered as the value that is held by the shareholders of the economic entity, referred to as the equity of the shareholders. This equity may be determined as the difference between assets and liabilities and may be defined as the number of shares that are held along with the value of shares.

How Creative Accounting Affects Shareholder Wealth in Investment Projects

The immediate impact of creative accounting is that it overstates the financial figures that are the basis of shareholder value. The overstatement of earnings per share and return on equity, and the improvement in the capital position of the bank, in turn, attract investors and increase shareholder wealth. In effect, the shareholders are responding to an overestimation of the true profitability and financial position of the bank. However, this overestimation is inherently unsustainable since shareholder value ultimately depends on the long-term ability of the business to generate cash and perform a thorough risk assessment. The creative accounting undermines the latter and creates a huge disconnect between the perceived and intrinsic value. The awareness of the problem causes a significant correction in the price of the stock. The stock price will be corrected immediately if the reserves are inadequate, if there are risks that are not on the balance sheet, and if the quality of the assets is declining faster than what the accounting statements show. This sharp correction in the stock price rapidly destroys the shareholder wealth that was accumulated [9].

The negative impact on the reputation of the bank caused by the confirmed accounting manipulation also undermines investor confidence, which is an important component of the valuation of banks. Once this confidence is breached, the stock may be downgraded by analysts, financial commitments withdrawn by investors, and the cost of new finance in the form of debt issues may be higher, thereby impacting shareholder value over the long term.

Previous Study:

Research Title: Creative Accounting Practices and Their Impact on Shareholder Wealth in Commercial Banks

Author: Haider Abdul Hussein Hamid Al-Mustawfi [10]

Journal: Journal of Management and Economics, Mustansiriya University, Volume 49, Issue 143, June 2024

This study aims to highlight the ways and means through which managers of economic entities implement various techniques for carrying out creative accounting practices within firms. This serves as a tool for earnings management, income smoothing, and off-balance-sheet financing. This practice is always associated with a favorable impact on the market position of the firm, which in turn improves the operating system of shareholder wealth, despite the fact that it is associated with incorrect profits. A firm that reports incorrect profits in order to achieve fictitious profits provides an incorrect representation of its financial information. This practice may lead to the downfall of firms due to incorrect judgments and scandals, as experienced by many firms, including Enron, WorldCom, and Harkin. The aim of this study is to highlight the different strategies through which profits are distorted, along with the ways and means through which management attempts to achieve its objectives, as well as highlighting the impact that it has on shareholder wealth.

The aim of the research is to emphasize the concept of creative accounting, as well as to enlighten the reader on the incentives that guide management in economic units. It is also aimed at enlightening the reader on the importance of shareholders' wealth in economic units, with the main aim of drawing several conclusions, with the most significant being that creative accounting techniques manipulate accounting figures with the aim of taking advantage of loopholes in existing accounting regulations and standards, which allow for certain degrees of flexibility. Such techniques also have the potential of impacting shareholders' wealth in both positive and negative ways, thereby underscoring the need for increased trust in the economic sphere. The study also draws several recommendations, with the majority being in line with the need to limit economic units in their choice of accounting policies or practices by limiting the number of options at their disposal.

First: Strengths of the Research

1. Thematic Significance

This study focuses on a theme that is of significant relevance to current accounting practice. The theme of creative accounting and its effect on MVA is of particular significance, especially in the Iraqi environment where there are insufficient governance structures and where there are challenges in overseeing private banking institutions.

2. Linking Creative Accounting to the Market Value Added (MVA) Index

The fact that market value added is employed as a valuation tool represents an up-to-date strategy, one that goes beyond regular performance measures that are not considered adequate for determining the cost of capital. From the theoretical point of view, this option appears to be consistent with VBM practices.

Second: Critical Observations and Fundamental Shortcomings

A. Descriptive Oversight: The data provided in Tables 1-6 clearly indicates that the incremental values of the banks' markets are negative over the three-year period. However, the researcher failed to provide any statistical basis for this phenomenon in relation to the Beneish index. The researcher merely referred to the Beneish index in a general and descriptive context.

B. Lack of Methodological Selection Criteria: The researcher failed to clearly define the criteria for the selection of these three banks out of the total population of the private banks operating in the financial market.

C. Inconsistent Treatment of the Concept of Creative Accounting: The researcher referred to creative accounting as both an acceptable practice in that it exploits the flexibility of the standards and as an illicit practice without clearly and consistently differentiating between the two concepts.

D. Assertion of the Existence of Creative Practices Without Proof: In several instances, the values of the M are above the negative threshold of -2.22. However, this does not prove the existence of creative practices. A deep and comprehensive analysis of the data should be carried out to assess each of the eight parts of the model and identify the areas of divergence. In addition, the researcher relied on the closing stock prices at the end of the year to represent the value of the market capitalization. However, it is more appropriate to rely on the average closing stock prices over the year.

E. Economic Value Added (EVA): The researcher emphasized the importance of Economic Value Added in the theoretical context of the research. However, the researcher failed to calculate the EVA**.**

Case Studies:

The Financial Implications of Misleading Shareholder Wealth Through Creative Accounting Techniques: A Case Examination

The banking industry's history can be characterized by an array of cases in which creative accounting techniques have led to a diminution of shareholder wealth. Firms in the wireless telecommunications industry are an illustrative example. Though their main business is in communications, their accounting practices, such as capitalizing operating costs, are indicative of possible scenarios. The banking industry's experience with the 2008 financial crisis offers an array of applicable examples. A case analysis of mortgage-backed securities (MBS) practices prior to 2008 is also called for. A number of investment banks used advanced models and selectively applied fair value assessments to justify an optimistic assessment of mortgage-backed securities, in spite of the fact that underlying mortgage loans were becoming increasingly delinquent. This innovative approach to assessing MBS allowed investment banks to reap higher trading income and avoid write-offs. However, with the collapse of the housing market, these valuations became indefensible. Stocks of many companies fell dramatically after it became known what kind of toxic assets they were holding. Everything that made people believe that the stocks could appreciate was based on false premises. Another notable case is the phantom account scandal at the aforementioned bank. Although this is not considered a balance sheet manipulation, it is considered the new form of managing the operational statistics to meet the sales goals. Employees were able to create millions of unauthorized customer accounts, which generated fraudulent fees that enabled the bank to inflate its revenues and earnings per share. This enabled the bank to maintain a high valuation compared to its peers, which benefited the management and the stock performance. However, the penalties, regulatory actions, and reputational damages that were suffered after the scheme was exposed led to significant shareholder litigation and subsequent declines in the bank's performance as the bank was forced to eliminate the fraudulent revenue and incur significant restructuring charges. This case shows that the creative accounting practices that are implemented to show operational and balance sheet success are equally damaging to the shareholders' wealth. (Khandelwal, V., et al., 2023).

Regulatory Response and Deterrence as Mechanisms to Mitigate the Costs of Shareholder Wealth Misrepresentation Arising from Creative Accounting

In the wake of huge failures such as those witnessed in 2008, regulatory bodies, such as the U.S. Securities Exchange Commission (SEC), as well as international standard-setting bodies such as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), have developed more stringent accounting standards. The changes introduced by such regulations primarily focus on derivatives, fair value measurements, and financial statement harmonization for special purpose entities (SPEs). Moreover, the Basel Accords have introduced more stringent requirements for tangible capital, which directly links the regulatory capital with the quality and transparency of assets [11]. Despite the development of such stringent regulations to mitigate the practice of creative accounting, there are still incentives for companies to engage in such activities. The management of such companies, particularly those with significant compensation packages for their performance in line with the company's performance in the stock market, continues to experience significant pressure to meet their performance targets. Therefore, to mitigate the issue of creative accounting, there is a need to remain vigilant through the implementation of internal controls, effective auditing mechanisms, as well as market supervision. When such accounting malpractices are discovered, shareholders often seek legal remedies for the recovery of their lost wealth due to such fraudulent activities.

Reputational Harm Arising from Creative Accounting Practices and Its Impact on Shareholder Wealth

For financial institutions, reputation is an extremely valuable intangible asset. The shareholder's wealth is dependent to a large extent on market perceptions of security and stability. Accounting ethics play a very important role in undermining the perception of the company in terms of such factors. In the case of a scandal involving the accounting system, loss of wealth will occur not only because of the reduction in stock price. Depositors may pull out money due to concerns of insolvency in what is called a "random run" although this problem occurs much less today due to the presence of deposit insurance. Traders may refrain from working with the bank or require collateral. The negative influence on the reputation of the bank in an accounting scandal situation is easily contagious and multiplies its effects on the financial performance of the organization. This process can create a vicious cycle with possibilities of takeover or insolvency. The shareholders face a permanent loss of capital and stock prices [12], [13], [14], [15].

The Concealed Expense: Information Asymmetry and Conflicts of Interest

In creating an environment suitable for creative accounting, the role played by information asymmetry is very important. This further makes the underlying inherent conflicts of interests associated with modern-day corporate governance more pronounced. Figures can be juggled not just to fool the shareholders but also for meeting other ends.

Shareholder trust in management decreases when it appears that the management is deliberately hiding the risks facing the organization. The costs of this loss of trust are enormous because the shareholders are forced to demand a higher equity risk premium. This in turn requires them to demand a higher confidence premium in order to offset the uncertainties that they face with regard to the quality of the earnings that the organization reports. Thus, if the shareholders suspect that the earnings per share are overstated by 20%, they are likely to discount the value of the stock by more than 20% in order to take into account the possibility that the earnings per share are actually lower and that this is in line with the self-serving interests of the management. This discounting mechanism is likely to be correlated with the reduced market capitalization and shareholder value even before any changes are made to the financial statements.

The pursuit of accounting objectives in the short term can also expose the organization to unforeseen risks. For instance, if the bank significantly lowers the loan loss provisions in order to meet the quarterly targets, it provides the organization with the incentive to make riskier loans in order to avoid the necessity of making provisions in the near future. The benefits that the management receives in the short term in the form of bonuses are negligible when compared to the long-term damage that is done to the shareholder value when the inadequately assessed loans that were made actually default**.**

4. Conclusions

The idea of earnings management among banks involves complex financial maneuvers that destroy the very foundation of generating value for the shareholder. Banks can manage their short-term performance measures through altering underlying assumptions, including loan loss provisions, by attaching too much importance to categorization of complex assets or conducting regular monitoring of off-balance-sheet risk. Even though such activities might generate positive short-term results for shareholders, the reality would be that the real state of affairs in banks is discovered later on, leading to wealth destruction, higher cost of capital, and damaging reputation of the bank. Capital adequacy ratios and disclosures represent regulatory constraints on such activities. However, as long as it is possible for the management to behave against the interest of the shareholder, there will always be a need to do earnings management. Finally, the creation of value for shareholders will be based on transparency.

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