

Osmanović, Azira; Šarić, Damir

Article

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Agora International Journal of Economical Sciences (AIJES)

Provided in Cooperation with:

Faculty of Economic Sciences, Agora University of Oradea

Suggested Citation: Osmanović, Azira; Šarić, Damir (2023) : IMPORTANCE OF INTERNAL CONTROL FOR CREATIVE ACCOUNTING, Agora International Journal of Economical Sciences (AIJES), ISSN 2067-7669, Agora University Press, Oradea, Romania, Vol. 17, Iss. 1, pp. 93-101, <https://doi.org/10.15837/aijes.v17i1.5766>

This Version is available at:

<https://hdl.handle.net/10419/302968>

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IMPORTANCE OF INTERNAL CONTROL FOR CREATIVE ACCOUNTING

A. OSMANOVIĆ, D. ŠARIĆ

Azira Osmanović, Damir Šarić

International Business-Information Academy Tuzla, Bosnia and Herzegovina

E-mail: azira.osmanovic1@gmail.com

Abstract. *Creative accounting enabled accountants to use accounting policies more flexibly. However, it was precisely this flexible application of accounting policies that led creative accounting to become synonymous with manipulative accounting in practice. Financial reports should reflect the actual state of business, but they are often subject to numerous manipulations. In order to prevent manipulations in financial reports, it is necessary for the company to have an established internal control system. In the research conducted through an online survey in Bosnia and Herzegovina, the connection between internal control and the use of creative accounting was investigated. The research confirmed two pre-set hypotheses that the use of creative accounting has an impact on the quality of financial reports, and that well-established internal control prevents to use of creative accounting.*

Keywords: *internal control, creative accounting, manipulative accounting, financial reports*

INTRODUCTION

The desire of users of financial statements is that financial statements provide objective, true and fair information. Precisely the information from financial reports is needed in the process of business decision-making and making business decisions. Investors and creditors use financial information to assess the quality of the company's results, as well as future cash flows associated with their investments. Realistic financial reporting implies that financial reports are prepared in accordance with the rules and regulations for financial reporting, that is, in accordance with accounting standards and regulations. Financial statements should not contain materially significant errors and irregularities, because the goal of compiling financial statements is to show the true and objective business of the company. Unlike real financial accounting, creative accounting includes all those procedures used to manipulate data in financial statements.

There are numerous irregularities in the company's operations, and often the consequences of fraud can be unfathomable. Precisely because of this, the need to introduce supervisory mechanisms, both external and increasingly internal supervision, first of all with the help of internal control and internal audit, was realized. Internal controls include a series of activities aimed at improving the quality of business processes. Company management shapes internal control systems. The goal of all employees should be to establish a quality system of internal controls. The task of internal controls is to detect illegal activities and to influence the prevention of such activities. Today companies pay more and more attention to risk assessment. Internal control can significantly affect the occurrence of errors and fraud in business.

I. Theoretical basis of the research

I.1. The term of creative accounting

Many people think that accounting is a "clean" job, and that financial fraud occurs outside of accounting. All over the world, including in Bosnia and Herzegovina, it is not an unusual situation that company owners and managers want to embellish the picture of the company's financial position, and try to show the company's performance better than what it really is. This is exactly the kind of "beautification" and "cleaning" that takes place in accounting. How the image of the company will be improved depends on the knowledge of the accountant.

Creative accounting at the very beginning had the task of enabling a realistic and objective presentation of the actual financial position and results of the company's operations through financial statements within accounting legal regulations. However, in practice, creative accounting has become synonymous with "manipulative accounting". Although financial reports should be true, fair and reliable, they are often subject to numerous manipulations. Manipulations that can be done often result from accounting standards, because accounting standards are often unclear and very complex, and assessments are subjective. In the beginning, creative accounting was not intended to be prohibited, but accountants were given the opportunity to apply accounting policies more flexibly. However, it is precisely this flexible application of accounting policies that has led creative accounting to become synonymous with manipulative accounting in practice. In this context, it is primarily based on whether there is flexibility and to what extent it is applied in accounting procedures (Belak, 2011).

The existence of flexibility, according to Mulford and Comiskey (2002), is necessary due to the economic environment and financial transactions that companies face, which in many cases are not similar in order for the same accounting practice to suit all of them.

Creative accounting can be defined as a process in which accountants use knowledge from the field of accounting standards and principles for the purpose of manipulating balance sheet positions and their values that are presented in financial statements. Creative accounting is not a one-time act, but creative accounting is a long-term process, a multi-year process that starts small and ends with a waterfall of accounting manipulations, but it is also a phenomenon that can be carried out in a legal and legitimate way and in accordance with the applicable accounting regulations, rules and standards (Negovanović, 2011).

Fraud mainly occurs where controls are weak, and where controls are not applied or do not exist. That is why it is very important to determine the level of internal controls in companies. It is precisely this strengthening of controls that reduces the possibility of fraud.

I.2. Purpose and motives for applying creative accounting

Based on the research, it was determined that there are numerous goals of using creative accounting in the company. If they are compared and analyzed in detail, we can conclude that these are goals, which are very important goals for management at all times.

Although different goals are stated by different authors, it is still possible to reduce them to the following four:

- maintenance of investor confidence,
- creation of bonuses, and use of stock options,
- preparation for takeover or defense against hostile takeover,
- postponement of income tax for future periods.

1.3. System of internal controls

Internal control plays an increasingly important role in the company's internal control system, and is reflected in the protection of assets, prevention and detection of fraud and irregularities that occur during business operations. Evaluation of the internal control system is carried out by an internal audit. Internal control was initially tasked with preventing and detecting fraud. Today, the tasks of internal control are more complex, so different definitions of internal control can often be found in the literature. "Internal control is a set of measures and procedures for constantly checking the operation of the accounting system and the business system in general with the aim of detecting and correcting errors before the audit procedure." (Vujević, 2003). The system of internal controls is based on control and organizational procedures, but also other measures and policies that are adopted with the aim of implementing the business policy adopted by the management, as well as protecting the company's assets. Internal control acts preventively, detects errors and frauds, ensures the correctness of accounting records, in order to have reliable financial information. Internal control is an extremely complex activity, which is extremely important for the company.

The internal control system is designed and implemented by the employees of the company at all organizational levels, but the management should make additional efforts so that the expected benefits are greater than the expected costs in order to achieve the effectiveness of internal control. The internal control system is established differently from company to company, primarily because of the different goals they have, but also because of the size of the company, number of employees, organizational structure, type of activity, etc. Internal control implies analysis of the environment or conditions in which control is carried out, then risk assessment, undertaking control activities, information and communications, and supervision and monitoring.

1.4. Creative accounting in the system of internal controls

Companies have their own specifics of work, organization, or activities. Establishing a quality and reliable system of internal controls in order to prevent the application of creative accounting is not easy to implement. Internal controls were created to protect the company from creative accounting and various frauds. In order to prevent creative accounting, internal controls must be applied at all stages of the accounting process, and include control of the input, processing and output of information from the accounting system. Internal controls include "drafting of written procedures that will define responsible persons, description of activities, procedures and execution deadlines and double signature records" (Bedeković, 2013). To prevent creative accounting, internal controls are focused on the division of duties and authorities, and the employee cannot make and hide mistakes, irregularities and fraud, or execute transactions, or have control over the company's assets (Gulin et al., 2012).

1.5. Overview of previous research

Many authors analyze the importance of internal control in preventing creative accounting. Tušek et. Al. (2014) define internal control as a series of procedures and actions that, through the principle of self-control, are performed by employees at all organizational levels, whose goal is to improve the efficiency and effectiveness of all business processes and operations as a whole. The Association of Certified Fraud Examiners (ACFE) (2020) lists fraud in financial

statements as the main forms of fraud committed by employees of the organization, along with corruption and embezzlement. Halilčević (2020) believes that in order for the internal control system to fulfill its role in preventing fraud, it is necessary to properly assess the risks faced by the company, and to design appropriate controls based on the assessed threats. Rajković (2021) believes that the growing number of frauds and financial scandals in the last few decades justifies the skepticism and fear of external users regarding the credibility of financial statements presented by reporting entities. The COSO framework (2013) states that "transaction controls are the most important controls in an enterprise, since they are directly related to risks in business processes established to meet set goals." According to Deloitte (2021) "understanding the most important risks that threaten the company and designing relevant internal controls to mitigate these risks can be a key differentiating factor in the growth and development of the company". Mahaček, Bolfek and Šakota (2015) believe that with the establishment of internal control, as well as internal audit, it provides greater opportunities for detecting and preventing fraud.

II. Methodology

II.1. Population and Sample

Empirical research that was conducted tried to prove what are the motives for accounting fraud, and what are the consequences of these frauds. The target population in the research were employees in accounting, finance and internal auditors on the territory of Bosnia and Herzegovina. A questionnaire was used to examine the effectiveness of internal controls and creative accounting procedures. 91 employees who duly returned the completed survey questionnaires were surveyed.

The paper set itself the task of investigating the significance of internal control in preventing the application of creative accounting.

In accordance with all the above, the paper sets out the main and one auxiliary scientific research hypotheses:

H1. The application of creative accounting has an impact on the quality of financial statements.
PH1. With a well-established internal control, the application of creative accounting is prevented.

II.2. Statistical Analysis

The conducted research is based on the collection of primary data, a method of surveys through a highly structured questionnaire intended for employees in accounting, finance and internal audits. Out of the total number of questionnaires sent to 120 e-mail addresses, in the period from October 1, 2022 to February 1, 2023, 91 duly completed questionnaires were returned, which is a response rate of 76.00% of the total sample. The response rate is considered acceptable for this type of research, but it is noted that the results of this research are not a rule, but are certainly a good guideline for future research.

Adequate control is considered to have been established if it was planned and designed by the management with the aim of managing the organization's risks effectively, and achieving the organization's goals efficiently and economically.

III. Results

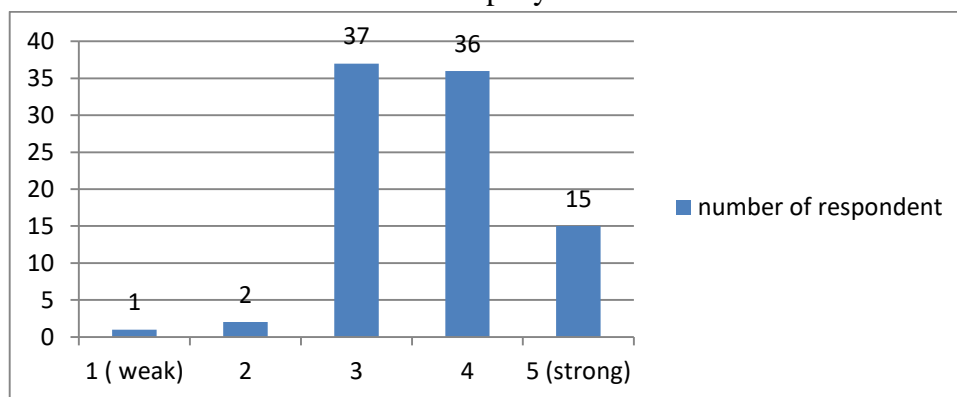
At the beginning, creative accounting aimed to enable accountants to apply accounting policies more flexibly, however, in practice, creative accounting has become synonymous with manipulative accounting. In order to prevent manipulations with accounting data, it is necessary to introduce internal controls.

This research sought to investigate whether accountants, financiers and internal auditors believe that internal control is important for preventing the application of creative accounting.

On the basis of 91 duly completed questionnaires, a new picture was obtained about the application of creative accounting and the efficiency of internal control. In the research that was conducted, the respondents made an exceptional contribution to a better understanding of the subject matter. Out of 91 respondents in the survey, 36 heads of accounting, 20 clerks employed in the accounting service, 27 clerks employed in finance, and 8 internal auditors gave answers to the questions.

Most respondents (68.1%) believe that the application of creative accounting affects the quality of financial statements. A smaller number (29.7%) of them believe that the application of creative accounting has little effect on financial statements, while there are the least number of those (2.2%) who believe that creative accounting has no effect on financial statements.

Figure 1. Surveyed according to the evaluation of the efficiency of internal control in the company

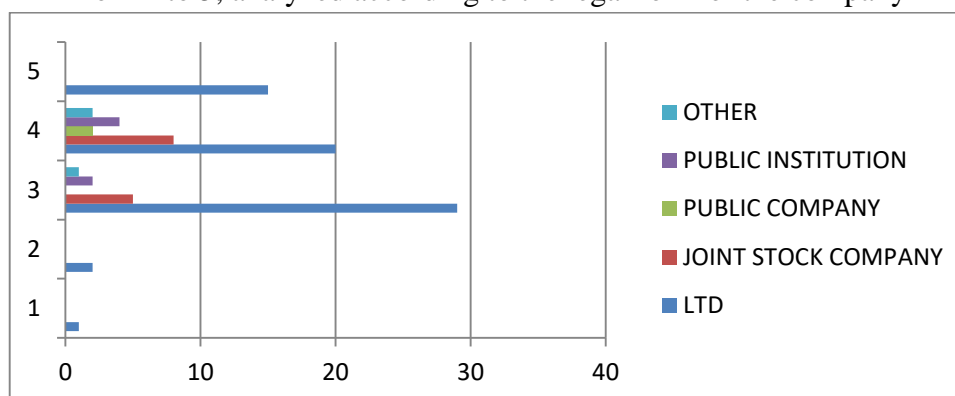


Based on the conducted research on the evaluation of the level of internal control, where the respondents rated the internal control in their company on a scale of 1 to 5, the fewest respondents (only 2 respondents) believed that internal control was weak in their company, while the most respondents declared for moderate control in the company (37 respondents), while 15 respondents declared that a strong internal control was established in their company (figure 1).

The research results show that the legal form of the company has no significant influence on the evaluation of efficiency, namely the largest number of respondents, regardless of the legal form, rated the internal controls as very good, good and excellent respectively, as shown on figure 2.

IMPORTANCE OF INTERNAL CONTROL FOR CREATIVE ACCOUNTING

Figure 2. Surveyed according to the evaluation of the efficiency of internal controls on a scale from 1 to 5, analyzed according to the legal form of the company



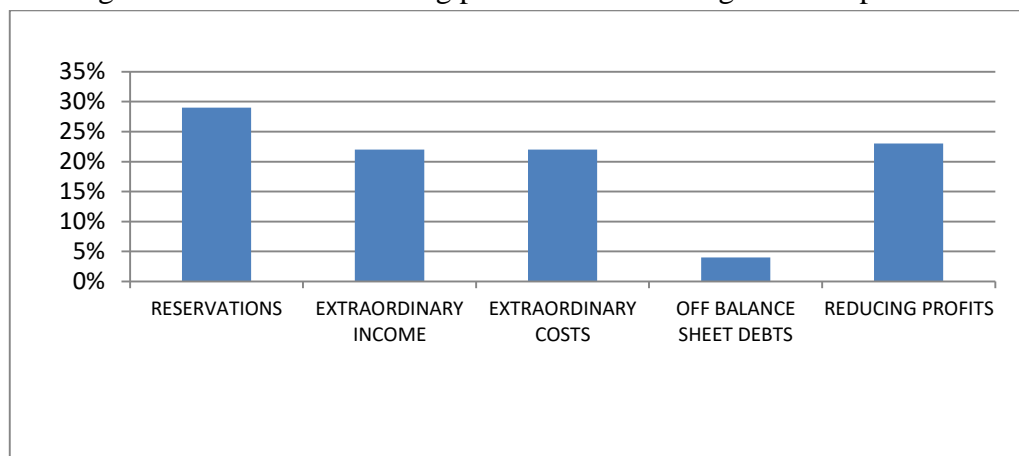
Based on the research, an analysis was made of the average efficiency rating of the internal control system according to the legal form, which is shown in table number 1. In the case of limited liability companies, although there is the lowest level of implementation, where they are established, internal controls are rated highly, and the average rating is the highest 3.69. Probably due to the smallest number of respondents, the highest rating was given to public companies with an average rating of 4. Then followed by institutions with an average of 3.67, joint-stock companies that have established internal controls to the greatest extent had the worst average rating of 3.62.

Table 1. Respondents according to the average assessment of internal control observed by legal form of the company

LEGAL FORM	AVERAGE GRADE
LTD	3,69
JOINT STOCK COMPANY	3,62
PUBLIC COMPANY	4,00
PUBLIC INSTITUTION	3,67
OTHER	3,70
OVERALL AVERAGE GRADE	3,73

The most common procedures of creative accounting in Bosnia and Herzegovina, as well as those applied in the world, refer to provisions, then extraordinary income and extraordinary expenses, as well as the reduction of earnings. Only four respondents mentioned off-balance sheet debts as a creative accounting procedure (Figure 3.)

Figure 3. Creative accounting procedures according to the respondents



These data are also confirmed by the analysis of financial statements, where it is observed that the most frequent manipulations occur precisely on the listed items in the balance sheets of companies in Bosnia and Herzegovina.

By applying multiple regression analysis, the assumption about the influence of creative accounting on the quality of financial statements was verified in the research.

Table 2. Statistical presentation of the influence of creative accounting on the quality of financial statements

Model	R	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. Change	F	Durbin Watson
1	,686	,450	,60202	,471	23,254	1	26	,000		1,756

The correlation coefficient R (0.686) reveals a medium-strong connection between the observed variables, the influence of creative accounting on the quality of financial statements. F (23.254) indicates that the results are statistically significant, and it is concluded that the application of creative accounting is related to the quality of financial statements. The obtained data confirm hypothesis H1, which assumes that there is a statistically significant relationship between the application of creative accounting and the quality of financial statements.

Table 3. Statistical presentation of the connection between internal control and the application of creative accounting

Model	R	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. Change	F	Durbin Watson
1	,644	,415	,63216	,418	18,546	1	26	,000		1,486

IMPORTANCE OF INTERNAL CONTROL FOR CREATIVE ACCOUNTING

The correlation coefficient R (0.644) reveals a moderately strong relationship between the observed variables, the connection between internal control and the application of creative accounting. F (18,546) indicates that the results are statistically significant, and based on this, the conclusion is reached that a well-established internal control affects the prevention of the application of creative accounting. The obtained data confirm hypothesis PH1, which assumes that there is a statistically significant relationship between internal control and preventing the application of creative accounting.

CONCLUSIONS

Accounting should be a "clean" job, given that it has principles that should be followed. However, as in any business, "creative" accountants appeared in accounting, and with them creative accounting. Creative accounting does not have to be illegal, but the question arises as to whether it is ethical or not. Financial reports should be true, fair and reliable, because only in that case they justify their role. Financial statements are often subject to numerous manipulations. Maneuvering space is found in accounting standards, which are often unclear and very complex, and assessments are subjective.

With the introduction of internal and external control systems in the company, it is possible to reduce, but not eliminate, the percentage of fraud and manipulation by employees or company management. In order for the company's management to confront errors and frauds that may appear in the financial statements, it helps a lot: a reliable accounting system, appropriate control procedures, as well as a clear definition of the policy of accounting and financial statements. Adequate human potential, an understandable code of ethics as well as the provision of continuous training for employees regarding accounting errors and manipulation of financial statements are also needed.

In the end, it can be concluded that the application of creative accounting does not only endanger the company that applies it, but also the entire economic system of the country. In the fight against this growing problem, companies cannot rely only on existing controls to prevent and detect fraud, but must clearly define illegal activities and sanctions for those who commit fraud. Discovering and researching the causes of fraudulent financial reporting, as well as a preventive approach and prevention of illegal and socially unacceptable behavior, aims to increase the level of security of users of financial information. Bearing in mind the responsibility that the accounting profession has towards the social interest, as well as the scope of forensic accounting in discovering the causes and techniques of fraud, it is very important to point out future activities in the direction of developing unique educational and certified programs at the state level. Given that criminal activities are represented in all spheres of society and are a burden to both developed and less developed countries, it is certain that this topic and the suppression of the application of creative accounting will be the subject of new considerations and further research.

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