

CREATIVE ACCOUNTING AND FIRM'S MARKET VALUE IN NIGERIA

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Abstract

The Enron scandal brought to fore the fact that a lot of companies' earnings are the result of accounting shenanigans. This discovery has not only cast doubt on the integrity of preparers of accounting reports, but has also led to loss of confidence in those who are supposed to check business executives namely; auditors, analysts and government regulators. Viewed from ethical angle, a large number of studies see the act as immoral with only few offering a justification of the behaviour on the basis of agency and positive accounting theories. This paper is motivated largely by the implications of these studies and seeks to find out if this practice obtains in Nigeria and if such practice enhances firm's value. Primary data were collected by means of questionnaires and a chi-square test was applied to test the stated hypothesis. It is found that the practice obtains in Nigeria and positively affects firm's value which can impact on its share price. Suggestions were offered on how the practice could be reduced.

Keywords: Deceptive Accounting, Forensic Accounting, Financial illusion, Ethics.

1) Introduction

Accounting is generally referred to as the language of business just as finance is branded the life blood of any organization. As a language of business, it is a process by which data relating to economic activities of an organization are classified, summarized, recorded and communicated to intended users for analysis and interpretation. The American Institute of Certified Public Accountants in Agboh (2007) sees accounting as the art of recording, classifying and summarizing in terms of money, transactions and events which are in part at least, of financial character, and interpreting the result thereof. Millichamp (1997) defines accounting as the process of identifying, measuring and communicating economic information to permit judgments and decisions by users of the information.

Irrespective of how accounting is defined, we can deduce the fact that it aims at communicating facts about the activities of an organization that can be quantified in monetary terms to varied interest parties. To satisfy this important role requires that the practice of accounting be done in uniform language and style. This is the basis for accounting concepts and conventions, complemented by accounting standards and company laws.

What has become worrisome, however, is the fact that many users of accounting information have had disappointing experiences by their reliance on accounting data. Companies

have gone into liquidation soon after providing 'beautiful' results of their operations to users. Sen and Inanga (2005) cited an example of Brentford Nylon in UK which collapsed in 1976 shortly after reporting a profit of £130,000. Also is Polly Peck in UK, which was placed under administration, three months after announcing interim results with enthusiastic comments on prospects for the year and beyond. In Nigeria for instance, most banks that collapsed in the late 1990's and early 2000's had fantastic audited results. This of course, became a challenge to the professional bodies whose members were auditors and accountants of such failed banks as society questioned the integrity of such experts. Society believe that accountants and auditors are obligated to the organizations they serve, their profession, the public and themselves to maintain the highest standards of ethical behaviour.

The basic question therefore is: Is it that the management of such failed organization lied in the reports provided to users? Why didn't auditors discover such misrepresentations? The answer lies largely on the fact that such organizations engaged in creative accounting. A lot of organizations are into this practice with the most celebrated ones in recent times being Enron Corporation in USA and in Nigeria, the African Petroleum Plc. Oluba (2009) observed that not a few banks in Nigeria are involved in a mild form of creative accounting. He found that banks directly lend to stockbrokers to buy their own shares to sustain demand pressure thus causing continued price rise without corresponding appreciation in underlying values or fundamentals.

Creative accounting, also called earnings management, aggressive accounting, according to Wikipedia (2008) is the manipulation of financial numbers, usually within the letter of the rules of law and standard accounting practices, but deviating from the spirit of those rules and certainly not providing the true and fair view that accounts are supposed to. Mulford and Comiskey (2002) identified creative accounting practices to include: recognizing premature or fictitious revenue, aggressive capitalization and extended amortization policies, misreported assets and liabilities, getting creative with income statement and problems with cash flow reporting. They added that managers play this game for rewards as favourable effect on share prices, lower corporate borrowing costs due to an improved credit rating, incentive compensation plans for officers and key employees and or political gains. Beside these, Merchant (1990) notes that general economic conditions are also an attracting factor for creative presentation of results.

Of these different attractions, the one of concern in this paper is the issue of favourable effect on share prices. The basic research questions put forward to address this are: Can a firm increase its market value by creative accounting? Do shareholders and investors take the accounting figures at face value? Or are the firm's shares traded in efficient, well functional markets in which investors can see through such financial illusion? Empirical studies on these issues differ and this study hopes to contribute to this intellectual discourse by gathering data from Nigeria to test the null hypothesis that Creative accounting does not have significant positive impact on firm's value.

The rest of the paper is structured into the following sections: section two is the literature review covering conceptual framework, theoretical framework and review of empirical studies, section three is methodology and discussion of results while section four is the conclusion and recommendations.

2) Literature Review

2.1) Conceptual framework

Perhaps, we start an exploration of the subject by looking at some definitions. Amat, Blake and Dowds (1999) see creative accounting as a process whereby accountants, capitalize on their understanding of accounting rules to manipulate the reported figures in books of account of a business. Naser (1993) sees it as the transformation of financial accounting figures to the desire of the preparers from what they actually are by taking advantage of the existing rules and or ignoring some or all of them. In the view of Gowthorpe and Amat (2005), creative accounting is the deliberate distortion of the communication between entities and shareholders by the activities of financial statement preparers who wish to change the content of the message being transmitted. To Sen and Inanga (2005), creative accounting, also called deceptive accounting, is the application of accepted accounting techniques which permit corporations to report financial results that may not accurately reflect the substance of business activities. Succinctly put by Copeland (1968), creative accounting involves the repetitive selection of accounting measurement or reporting rules in a particular pattern, culminating in the reporting of stream of income with a smaller variation from trend than would otherwise have appeared.

Similar in meaning to creative accounting when applied to accounts is window dressing. But this is much broader as it can be applied to other areas (money terms.co.uk). Earnings management is also synonymously used with creative accounting. Healy and Wahlen (1999) define this as the use of judgment by managers in financial reporting and in structuring transactions to after financial reports with the intent to either mislead some stakeholders about the true economic performance of an organization, or influence contractual outcomes that depend on reported accounting number. To the extent that management seeks loopholes in financial reporting standards that permit them to adjust the numbers as far as is practicable, earnings management is a fraud and it differs from reporting error.

While agreeing that creative accounting distorts information, it is important to identify the precipitating elements that make it thrive. In this regard, Schipper (2000) identified the following: (i) level of enforcement of accounting standards and the supporting regulations, (ii) auditing and auditors, (iii) the structure, process, independence, expertise, incentives and resource base of the standard setting organization (iv) the effectiveness of mechanism for identifying and resolving interpretative questions. Fearnley and Macve (2001) observe that many nations' systems are weak on these elements. Even international accounting regulation is vulnerable in respect of enforcement mechanism and in auditing and auditors (Cairns, 2001). They attributed this to weak support mechanism for auditors, lack of effective sanctions against directors and divergence in legal framework and practice.

Creative accounting has now become a topical issue in accounting practice. This is because of the ethical perspective attached to it. On one side of the argument is that moral rules should apply to actual action. The other view is that an action should be judged on the basis of the moral worth of the outcome. Writing in defense of creative accounting, Revsine (1991), drawing from the literature on agency theory and positive accounting theory, offers the selective financial misrepresentation hypothesis wherein he shows that both managers and shareholders can benefit from 'loose' accounting standards that provide managers with latitude in timing the reporting of income.

Notwithstanding the above views, the practice of creative accounting should throw challenges to auditing. The Enron Scandal should teach the business world a lesson. The Scandal Shook America's Stock Markets and dampened investor's confidence. Investors' fears that other companies could be involved were confirmed when the scandal hit several leading telecommunications firms. Between year 2000 and mid 2002, prices of stocks for the nation's largest companies fell by more than 33% while technology stock dropped 70%. More than 700 companies had to restate earnings from the previous five years, admitting tacitly that they too engaged in creative accounting. Perhaps therefore, a quarter of operating earnings by top 500 companies from 1997 to 2000 was the result of accounting Shenanigans (Lindstrom, 2009). Clearly therefore, that it is incumbent on management to assert that accounts have been prepared properly, offers no protection where those managers have already entered into conscious deceit and fraud. To this end, forensic accounting should be employed by auditors and in the process should distinguish fraud from error by identifying the presence of intention.

2.2) Theoretical framework

Recall that the focus of this paper is to find out if creative accounting impact on firm's value. Implicitly, we are concerned with whether accounting information enables the capital market to discriminate between different securities. The different empirical findings that capital market reacts to corporate announcements, accounting changes, reported and non- reported earnings to mention but a few, implies financial signaling. This can therefore make management to believe that investors rely on accounting information in adjusting their stock level trade. This belief can therefore make management to engage in creative accounting. Based on this link, this paper is therefore anchored on the efficient market model.

The pioneering works that culminated into the development of efficient market model are those of Bachelor (1900) in Cootner (ed) (1964), Workings (1934), Kendall (1953), Samuelson (1965), Mandelbrot (1966), Fama (1965;1970), Roberts (1959) and Osborne (1959). Efficient market has been defined variously. But that of Fama (1970) stands out as the commonly quoted definition because his' formed the basis for empirical tests and investigations on the subject. To him, efficient market is one in which prices fully reflect all available information. From this definition, capital market efficiency implies that

$$\phi M_{t-1} = \phi_{t-1} \text{-----} (1)$$

Thus, the information set used by the market to determine security prices at time t-1 includes all available information. That is, any piece of information relevant to determination of security price is impounded by the market. Further implication of this, is that the joint probability density function for security prices at time, t, assessed by the market at time, t-1, on the basis of the information set ϕM_{t-1} is the same as the joint probability density function for security prices at time, t, that is "implied by" the information set ϕ_{t-1} (Reilly and Brown, 2000; Sharpe, Alexander and Bailey, 2005). Thus, $f(M(P_{1t}, P_{2t} \text{-----} P_{kt}/\phi M_{t-1}) = f(P_{1t}, P_{2t}, \text{-----} P_{kt}/\phi_{t-1}) \text{-----} (2)$

For the above characterization of an efficient to stand, the sufficient conditions are: (i) there are no transaction costs in trading, (ii) all available information is costlessly available to all market participants and (iii) all participants agree on the implications of current information for the current price and distribution of future prices of each security. But suffice to say that these conditions do not imply a specific equilibrium model of price determination. Rather, that

whatever asset pricing model used, the resultant set of equilibrium price fully incorporates available information at time $t-1$ (Fama, 1970).

Important implications we can deduce from equations (1) and (2) are: (i) Capital asset prices adjust instantaneously to new information and (ii) capital assets adjust to new information in an unbiased manner. That equation (1) is valid means that accounting information is used by the market. Creative accounting can therefore transmit information which the market can interpret as reflecting the firm's value. However, the test of efficient market hypothesis requires specification in more details, of how equilibrium prices at $t-1$ are determined from ϕM_{t-1} . This is the crux of the Capital Asset Pricing Models. That the efficient market model has advanced our understanding of the actual operation of real world capital markets makes it one of the most successful models within the financial economics literature.

2.3) Empirical Evidence on Creative Accounting

Ever since the word creative accounting was first used in 1968, researchers have studied different facets of the concept. A large number of literatures that viewed creative accounting from ethical perspective see it as fraud and therefore a challenge to the accounting profession. Gowthorpe and Amat (2005) characterized ethical issues in accounting by positing that accounting regulation shares many features with systems of law. These systems are societal constructs which mirrors issues of individual morality and fundamental moral values as truthfulness. Therefore, respect for rule of law, justice, fairness and morality are elements that help define ethical issues in accounting. They found two categories of manipulative behaviour namely: (i) macro manipulation that is the lobbying of regulators to persuade them to produce regulation that is more favourable to the interest of preparers of accounts. They found this is in USA with respect to Goodwill accounting. (ii) Micro manipulation where accounting figures is doctored to produce a bias view at the entity level. They observed this in large number in Spain. Both forms of behaviour are seen as morally reprehensible.

Conner (1986) notes that creative accounting amounts to fraudulent reporting as it creates an illusion that the entity is healthier and more prosperous than it actually is. Sen and Inanga (2005) found evidence of creative accounting by firms in Bangladesh which they traced to conflict of interest amongst different groups that the accountant wants to serve. Accounts are therefore prepared to serve the particular group the accountant so wishes. Schiff (1993) states that investors should beware of taking a company's financial report on the face of it as it could be a recipe for disaster. He remarked that the earnings per share (EPS) which is what investors actually pay for when they invest can be easily goosed. Ways of doing this include; consolidating own subsidiary's income and net worth, capitalizing expenses instead of writing them off and hiding pension liabilities. Leung and Cooper (1995), in a survey of 1,500 accountants in Australia, found that creative accounting as an ethical issue ranks above tax evasion. Merchant and Rockness (1994) investigated the motives for creative accounting and found that explicit self interest motivated creative accounting got higher disapproval than where the motive is to promote the company. Also found is that accountants are more critical of abuse of accounting rules than of manipulation of transaction. Fisher and Rosenzweig (1995) proffer explanations on the findings for accountants' attitudes.

Evidence of practice of creative accounting has been found to be global (Sen and Inanga, 2005). Here in Nigeria, Izeze (2008) found proof of practice of creative accounting in the books

of oil multinationals. He remarked that figures of oil transactions submitted to Nigerian National Petroleum Corporation (NNPC) and Department of Petroleum Resources (DPR) are largely cooked up and that for a long time, the oil multinationals in Nigeria have practiced creative accounting accidentally fleecing the country of its enormous fortunes. Also, management of African Petroleum Plc had used creative accounting to hide a debt of ₦ 23 billion during the privatization of the company (Proshare, 2009). This act is the antecedent of its share scandal. Amat, Blake and Dowds (1999) submit that the incidence of creative accounting is common, deceitful and therefore undesirable.

On whether investors are able to see through the financial illusion of creative accounting, a plethora of studies have found that they are unable. Healy and Wahlen (1999) report that investors do not see through creative accounting and that creative accounting prior to equity issues does affect share prices. Breton and Taffler (1995) added that signaling can be misinterpreted or ignored even by relatively sophisticated users. Dechow and Skinner (2000) remarked that certain categories of investors have limited information processing ability of what is contained in the notes to the financial statements. They therefore argued that users may not be able to adjust for creative accounting even if financial statements provide sufficient information. Some studies however disagree with this position. For instance, Dharan and Lev (1993) found poor share price performance in the years following income accounting changes. Also, Amat, Blake and Dowds (1999) note that in an efficient market, analysts will not be fooled by cosmetic accounting charges. They remarked further that directors can use creative accounting to delay release of information to market thereby enhancing their opportunity to profit from inside knowledge when they engage in “insider dealing”. This divergent opinion is an impetus for research in this area.

3) Method of the study

The research design for this study is the survey design method where a fractional part of the population is studied. The choice of this method stems from the fact that it has been successful in research of this nature. Sen and Inanga (2005) successfully used this method in their study on creative accounting in Bangladesh. Leung and Cooper (1995) used it in Australia, Naser (1993) in U.K, Amat and Blake (1996) in Spain, Amat, Blake and Dowds (1999) in New Zealand. This paper will therefore adopt the research procedure in these studies so as to ensure the validity and reliability of the research instrument. In addition, the questionnaire, the instrument for data collection, was validated by a senior lecturer in the Department of Accounting and Finance, who is a Chartered Accountant and also versed in academic research.

The questionnaires were administered to selected respondents to generate the primary data. The respondents were drawn from Chartered Accounting firms and Stock Broking firms in Benin-City using the simple random sampling method. It was possible to capture representative firms in Benin-City, because of the existence of a branch of Nigerian Stock Exchange there. The questionnaires were thus administered there. A total of ten firms were selected (see appendix) on which a total of 140 questionnaires were administered. Of these, 110 questionnaires were retrieved as useable. The Chi-square test for goodness of fit is adopted to test the hypothesis as it has been found useful as a non – parametric test in analyzing frequency data (Whawo, 2000).

The Chi-square formula adopted is:

$$\chi^2 = \sum \frac{(O)^2}{E} - N$$

Where: O = Observed frequency

E = Expected frequency which is equal to N/K

N = Size of sample

K = Number of cells

The appropriate degree of freedom is K-1. The test is carried out at 5% level of significance. Since the hypothesis is a directional hypothesis, a one- tail test is required.

4) Data Presentation and Analysis

The responses to the questions that will help in testing the hypothesis are presented and analyzed in table 1 below.

Table 1: Analysis of Responses.

Creative Accounting Variables	Impact on Firm's Value		
	High	Moderate	Low
Recognizing Premature or Fictitious Revenue.	80	20	10
Getting Creative with income statement	70	24	16
Aggressive Capitalization and extended Amortization	62	30	18
Exaggerated non – recurring items	76	26	8
Selling off low cost basis assets	58	30	22
Under accruing expenses	48	28	24
Intentional minor breaches that aggregates to material breach	66	28	16
Total	460	196	114
Average observed responses (to all 7 questions)	65.71	28	16.28

Source: Field Work 2012

$$\text{Now, } E = \frac{N}{K} = 110/3 = 36.67$$

$$\begin{aligned} \text{Thus } \chi^2 &= \frac{(65.71)^2}{36.67} + \frac{(28)^2}{36.67} + \frac{(16.28)^2}{36.67} - 110 \\ &= 146.35 \end{aligned}$$

The degree of freedom is $K-1 = 3 - 1 = 2$. Therefore, the critical value of chi-square for 5% level of significance at 2df is 5.99.

Decision: The calculated chi-square of 146.35 is greater than the critical value of 5.99. Consequently, the null hypothesis is rejected. We can conclude therefore that creative accounting have significant positive impact on firm's value.

4.1) Discussion of Results

The tested hypothesis revealed that the practice of creative accounting have significant positive impact on firm's value in Nigeria. This is corroborated by the fact that 85.5% (94 respondents) agreed that financial reports are potent means by which managers can convey information about their firms. In terms of motivations for creative accounting, 78 respondents (70.9%) ranked to increase firm's value and hence share price as the highest. This was followed by reduce tax obligations, 18.2%, and finally conflict of interests, 10.9%. Also, 76.4% of the respondents are of the opinion that creative accounting is detestable from ethical perspective.

This study also found that investors (especially individual investors) take accounting information as correct especially when they are from audited accounts. Thus while the preparers of accounts have learnt the skills of creative accounting to deceive, users are ignorant of such and therefore does not look in between the lines of financial statement. More also, the regulators of auditing and accounting lack the legal and infrastructural framework for effective regulation. Again, the stock market in Nigeria is relatively less efficient in providing mechanism to screen information. As a result, most individual investors trade on the basis of herd instinct theory and therefore follow what major shareholders are doing. It was discovered that directors who are insiders and major shareholders do capitalize on this to direct the movement of their share price as they desire. This is the case with African Petroleum Plc share scandal.

Now, a firm's value is:
$$\frac{\text{Net Operating Income}}{\text{Overall capitalization rate}}$$

To the extent that account preparers can manipulate Net Operation Income, they can influence the value of their firms. Interestingly, it has been shown that accounting information is a signaling device used by management to convey information; accordingly, stock markets have been found to react to such signals. In sum, this paper confirms the findings of Sen and Inanga (2005) that creative accounting is a global phenomenon prevalent in many countries, Healy and Wahlen (1999), and Dechow and Skinner (2000) on the ability of creative accounting to influence share price. But contradicted that of Dharan and Lev (1993) on the same subject.

5) Conclusion

The paper has looked at the impact creative accounting could have on a firm's value. Statistical evidence revealed that it can positively affect firm's value. This being the case, it implies that most investors are not able to see through the financial illusion of creative accounting. They could therefore be acting according to the prospect theory of Kahneman and Tversky (1986) which posits that individuals often tend to use cognitive heuristics when faced with the complex task of assigning probabilities to uncertain outcomes. This has some important implications for the enforceability of standards whether international or local. That business is not exempt from

morality suggests that activities of account preparers as moral agents can be questioned. That created financial statements suits the purpose of the preparers make it unfair to users, and tend to undermine the authority of regulators.

6) Recommendations

In view of the above, the following recommendations have been made: (i) Accounting Profession in Nigeria need to give much importance to ethical codes. It must continually set financial reporting standards as different loopholes are uncovered in the existing standards. This is what New Zealand did in the 1990s that helped it curb creative accounting practices. (ii) Sound stock market with relevant legal and market infrastructures should be put in place. Along this line, the current move whereby quoted firms are required to present their accounts first to stock market operators before presenting it at annual general meeting of shareholders should be sustained and legalized. (iii) Punitive measures should be taken against culprits by accounting bodies, courts and government, (iv) the practice of forensic accounting which integrate accounting, auditing and investigative skills should be embraced. Creative accounting like a bubble can have serious devastations on organizations when it bursts. For instance, the stock market downturn of 2002 in U.S was precipitated by accounting shenanigans at Enron, World Com, AIG and other leading firms. As a two edged sword, management should be careful with its practice.

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Appendix

Names of Selected Firms

- i. Anjous Uku and Eweka Chartered Accountants
- ii. Dolor Ogbebor Associates
- iii. Partnership Investment Company Ltd
- iv. Bestworth Asset and Trust Ltd
- v. UIDC Securities Ltd
- vi. BGL Securities Ltd
- vii. Cashcraft Asset Management Ltd
- viii. Intercontinental Securities Ltd
- ix. Mainland Trust Ltd
- x. Amyn Investments Ltd

Questionnaire

- Q1 Do you think that accounting reports convey information to investors?
Yes [] No [] Don't know []
- Q2 Is financial report a potent means by which managers can convey information about their firms? Yes [] No [] Don't know []
- Q3 Do Nigerian investors take audited reports as authentic and signifying the true state of the company's affairs? Yes [] No [] Don't know []
- Q4 Are you aware that most preparers of financial reports engage in creative accounting? Yes [] No [] Don't know []
- Q5 Do you think financial regulators have what it takes to check the practice of creative accounting in Nigeria? Yes [] No [] Don't know []
- Q6 As an investor, how would you feel if you discover that your company management has been cooking the books of accounts presented to shareholders? Very unhappy [] unhappy [] Indifferent []
- Q7 In rank order of 1st, 2nd, 3rd, what do you think are the motivations for Creative accounting in Nigeria?
- To increase Firm's value and hence share price []
- To reduce tax obligations []
- Conflict of interest []
- Q8 Do you support the practice of creative accounting?
Yes [] No [] Don't know []

- Q9 What impact do you think the following creative accounting activities have on the firm's value?
- (a) Recognizing premature or fictitious revenue boost Net operating Income. High []
Moderate [] Low []
 - (b) Getting creative with income statement to boost PBIT. High [] Moderate [] Low []
 - (c) Aggressive capitalization and extended amortization policies to smooth income and present picture of growth in EPS and DPS. High [] Moderate [] Low []
 - (d) The use of exaggerated non-recurring items to increase pro-forma earnings. High []
Moderate [] Low []
 - (e) Selling off low – cost basic assets to report gains and hence present picture of profitability. High [] Moderate [] Low []
 - (f) Under – accruing expenses to enhance Net operating income. High [] Moderate [] Low []
 - (g) Intentional minor breaches of financial reporting requirements that aggregate to a material breach. High [] Moderate [] Low []
- Q10 From an ethical angle, is creative accounting detestable?
- Yes [] No [] Don't know []
- Q11 If Creative accounting is morally reprehensible, indicate what possible measures to take to curb it?
- (a) Accounting profession needs to give much importance to ethical codes
 - (b) Should stock market with relevant legal and market infrastructures
 - (c) Punitive measures should be taken by accounting bodies, courts and government against culprits
 - (d) Forensic accounting should be introduced
 - (e) All of the above
 - (f) Any other (please specify) -----