Creative Accounting – Not Just a Private Sector Problem

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Abstract

The degree of attention paid to the question of aggressive and creative accounting practices has increased significantly in the wake of a string of high profile corporate collapses in the United States, as well as other jurisdictions such as Australia, in which creative or inappropriate accounting practices were implicated as causally related to the magnitude of losses ultimately borne by investors. This interest has been evident in the level of media attention focused on creative and aggressive accounting, as well as in a heightened level of publishing interest in this subject.

Despite this now evident higher level of interest in creative accounting and financial reporting issues, it seems to have gone relatively unremarked that "creative" accounting is not a phenomenon quarantined to the private sector alone, and that there are large pockets within the public sectors of certain jurisdictions, including Australia, the jurisdiction on which this paper focuses, where creative, unusual and aggressive accounting practices may present as significant a set of problems for decision makers and financial statement users as in private sector settings.

This paper discusses several examples of creativity in financial reporting and policy decisions within the public sector of Australia, discusses the materiality of these techniques, as well as the incentives which appear to have driven their implementation.

1. Introduction

Several recent high profile corporate collapses have focused attention once more on the issue of truth, fairness and creativity in financial accounting and reporting. In the United States, capital markets are said to have contracted a dose of "Enronitis" in the wake of the spectacular collapse of what was one of America's largest corporations. The symptoms of that "disease" include greater scepticism in relation to reported financial results, and a growing propensity to "sell first, ask questions later". In Australia, a string of high profile collapses in the telecommunications, aviation and financial services sector have similarly shaken investor confidence in the degree to which faith can be placed in the image of organisations' financial position and performance as evidenced in their audited, published financial statements.

In both jurisdictions, the soul searching has extended beyond the question of the substance of the financial statements themselves, into examinations of audit independence, the degree to which conjoint attest and non attest services ought be provided by audit professionals, and the impact of joint service provision on the effectiveness of the audit and assurance outcome.

Importantly, the bulk of the attention created by the recent spate of high profile collapses has been focused on the private sector. Investors and other capital market participants are increasingly demonstrating concerns about the extent to which markets can be seen as appropriately informed, and price formation as efficient. This has left little room for contemplation of whether or not problems with similar antecedents may be manifesting themselves within public sector settings as well as private sector settings.

Initially, this line of questioning may appear surprising. It is true for example, that in the case of government agencies funded through the annual budget process, or even in the case of state owned corporations or government trading enterprises, there is little reason to expect gaming in the development of annual financial statement numbers. After all, there are no teams of analysts projecting future earnings per share, and the only investors, the government (at least in a direct sense), have the power to set the rate at which any dividends are to be paid back to the coffers of central financial agencies.

However, examined in more resolution, the propositions above do not remove the chance that forces resulting in creative accounting processes are afoot within public sector settings. Rather, they suggest that the motivation for the adoption of aggressive or creative accounting practices may differ substantially from the traditional stories told in private sector settings. Those stories often revolve around the desire to manipulate reported earnings in a bid to avoid disappointing the market, or around engagement in "big bath" accounting in order to ease construction of a platform from which future earnings growth can be delivered.

Matters differ significantly in the context of the public sector. The manipulation of earnings numbers is unlikely to represent a meaningful motivation for the adoption of creative accounting techniques, with the possible exception of the case of state owned corporations and government trading enterprises, where the level at which dividends are declared may arguably be seen to be a function of reported profits or surpluses.

Despite this, it is the central contention of this paper that creative accounting practices may be found within public sector settings. Further, and a result of significant interest, it is arguably the case that in at least some public sector settings, a reversal of the traditional locus of creativity problem has taken place, such that the source of creative accounting proposals and practices is no longer the agent, but rather, the principal. Translated into concrete terms, whereas in private sector settings the agency perspective gives rise to an expectation that there will be conditions under which agents will attempt to maximise their own utility by manipulating the reporting of financial variables to their principals, in some public sector settings, it appears to be the case that principals have been the source of impetus for the adoption of creative accounting practices, their direct agents being a force of resistance against such initiatives.

This paper commences with a brief review of the meaning commonly attached to the term "creative accounting", as well as the explanations commonly advanced for the factors motivating the choice of creative accounting policies by actors in organisational settings. The study then proceeds to an examination of creative accounting practices in the Australian public sector, detailing and contrasting the incentives for adoption of such techniques implicit in the public sector with those commonly argued to exist in private sector settings. Finally, a review of the materiality and possible consequences and effects of creative accounting choices in the public sector is undertaken.

2. The Concept of Creative Accounting

It has been observed that the proper role and object of accounting standards is to reduce permissiveness as it relates to observed accounting and financial reporting practices, and to thereby reduce the degree of diversity of observed accounting and financial reporting practices [1]. This desire to reduce diversity of practice and permissiveness, expressed by many regulators over an extended period of time, can be argued to be primarily related to the desire on the part of standard setters to maximise the serviceability of financial reports for the purposes of assessing solvency, profitability, stability and other key financial parameters of reporting entities, that is, to minimise the incidence and impact of creative accounting and financial reporting practices on financial statement users and financial decision makers.

Creative accounting has been variously defined. For some authors, the term has connoted the existence of deliberate policies aimed at deceiving shareholders, creditors and others in relation to a company's financial wealth or progress [2], while others have gone so far as to label such practices not merely creative, but feral [3]. Whatever the case may be, the subject of creative financial accounting and reporting practices, whilst of interest over an extended period of time, appears to have become far more fashionable in recent times, no doubt as a direct result of recent revelations from across the globe of profoundly material and misleading financial reporting practice, authors such as Mulford & Cominskey [4] as well as Schilit [5] making notable recent contributions. Earlier contributions included those by Griffiths [6], Naser [7] and Smith [8], not to mention perhaps the classic contribution to the field a generation earlier still, by Briloff [9].

A factor all of these works have in common is their concentration on accounting practices in for profit, private sector settings. While understandable, the effect of this focus has been to leave a void in the literature on this matter as it pertains to public sector institutional settings and applications. It may well have been the case, until the mid 1980s, that there was very little call for such a focus, given the almost exclusive reliance by governments, their agencies and controlled trading enterprises on cash based, stewardship focused accounting and accountability regimes. However, in those jurisdictions in which contestability, competition and "private sector" style accounting and accountability practices were infused into the budget funded public sector and government trading enterprise sector from the mid 1980s onwards, a climate in which creative accounting practices might be expected to find room to flourish was created.

In private sector settings, the concept of creative accounting is usually associated with the expedients of massaging earnings numbers to better suit the ends of utility and wealth maximising agents, or alternatively (or conjointly) massaging balance sheet numbers to similar ends, both with a view to understating liabilities and overstating assets. Schilit (see reference 5) classifies creative financial accounting techniques into seven key categories, being:

1. Recording revenue too soon.
2. Recording bogus revenue.
3. Boosting income with one time gains.
4. Shifting current expenses to a later or earlier period.

5. Failing to record or improperly reducing liabilities.
6. Shifting current revenue to a later period.
7. Shifting future expenses to the current period by means of special charges.

Each of these techniques can be argued to have as its core motivation the distortion of outsiders' views of entity financial position and performance on a period by period basis. The rationale for such distortion is, under an agency theory perspective, commonly argued to stem from the efforts of agents (preparers of financial statements) to maximise their wealth at the expense of principals, for example by using creative financial accounting techniques to justify bonus and other incentive payments and rewards which would not, without the effect of the period by period creativity, accrue to the individuals or collective of individuals involved.

In the public sector however, it is unlikely that an incentive based story such as this will offer a persuasive explanation for creativity in financial reporting. There are several reasons for this, but chief amongst them is the general lack of performance based pay structures, and the reality that even where these do exist they are limited when compared to private sector schemes, and usually anchored in key operational rather than financial variables. Thus even though it is not difficult to accept that the public sector, like the private sector, may be populated by utility maximising agents who would, given the opportunity to do so, improve their wealth by engaging in unchecked creative financial accounting and reporting practices, the reality is that the actual economic and financial incentive to do so is largely erased as a result of the radically different institutional and cultural parameters of the public service in most jurisdictions.

If this intuition is correct, then the capacity to observe the incidence of creative accounting and financial reporting in practice within the public sector suggests that the root cause of these practices lies not with the agents themselves, but in some other source. However, prior to turning attention to this question further, it will be expedient to set out examples of creative accounting in practice in a public sector setting.

3. Creative Accounting in a Public Sector Settings

It is unnecessary in the present context to catalogue observed incidences of such phenomena exhaustively. A small number of case studies will suffice to demonstrate a concept more generalisable than an in depth examination of individual financial pathologies. These case studies, in turn, examine the enforcement of an "optimal capital structure" policy on government controlled agencies and entities in certain Australian jurisdictions, the adoption of asset valuation processes reliant on replacement rather than historical asset costs, and the implementation of capital charging systems into widespread practice.

The first of these, the adoption of "optimum capital structure" requirements may at first glance appear to be of little interest, and to have correspondingly little capacity to excite interest in the context of a discussion on creative financial reporting and accounting practices. Yet capital structure, such as it is, must ultimately be represented through the lens of an entity's financial statements. Thus policies embarked on to systematically alter or bias entity capital structures in one direction or other would, ex post, have significant impacts on the presentational qualities of entity financial statements, especially with respect to balance sheet structure, but also in relation to the quantum of expenses directly related to the cost of capital.

Quite apart from the relatively abstract question of whether or not such a phenomenon as an optimum capital structure does or can exist (and we know that under a range of restrictive conditions, capital structure choice is value irrelevant – hence calling into question the sensibility of the nomenclature of optimisation inherent in the current discussion), the adoption, normatively, of a desired balance between debt and equity, where such a balance had not previously been mandated, would be expected to have material effects on the appearance, ex post, of the resultant financial statements of affected entities.

Thus, in Australia, when the governments of several jurisdictions decided that the balance sheets of their controlled government trading enterprises ought to reflect an "optimal" balance between debt and equity (in practice meaning higher leverage than had been the historical norm), the balance sheet and profit and loss reports of the entities responded materially, earnings being materially impacted on as a result of higher "interest" charges on debt, the balance sheet looking correspondingly less robust as what had traditionally been treated as equity was reclassified as debt.

In a strict contractual sense, it usually was the case that capital classified as "debt" on the balance sheets of such entities did indeed bear debt's hallmarks. It followed that payments made to service that debt ought reasonably be treated as period expenses, with a commensurate dampening of period earnings. The substance of affairs was considerably different. Since all debts of the government trading enterprises the subject of this discussion were raised on behalf of those enterprises by a central government borrowing organisation, and ultimately guaranteed by respective jurisdiction governments, the economic substance of entity financing arrangements diverged considerably from the arrangements' strict contractual form.

In substance, all available capital, whether treated in form as debt or equity, came from one font – the owner government of each entity. Since only one party was responsible for the provision of the entirety of the capital base of each government trading entity, the argument that a meaningful distinction between debt and equity exists falls down, in favour of the argument that all funding, ultimately, is best seen as equity. The distinction between debt and equity is meaningless in contexts where no claimant can meaningfully claim preference or priority over any other claimant. Since one entity was, in the case of the government trading enterprises the subject of this discussion, responsible for materially all the utilised capital, no such preference or priority could be asserted to exist.

Thus while in substance the differences to the economic and operating realities of government trading enterprises subject to optimal capital structure directives were immaterial at best, in form, the financial position and performance of such entities could be seen to vary radically. Apparent profitability, rates of return on equity and assets as well as leverage changed dramatically. Perhaps more importantly however, the major source of cashflows between trading enterprises and their government masters became instantly less politically visible, now classified as interest, rather than the traditional and more identifiable dividend flow. Although one could, despite concems relating to the applicability of private sector accounting techniques to public sector settings [10], see quite strong arguments for the adoption of accrual based commercial style financial statements in the context of commercially focused trading enterprises, irrespective of by whom owned, this does not negate the possibility of collateral effects. One of these may be the adoption of a particular accounting or financial reporting technique based on the desire to actively shape perceptions, rather than provide appropriate insights into the financial performance and position of the entities so displayed [11].

A second consideration worth briefly reviewing in this context is the widespread decision, throughout the public sectors of a majority of Australian jurisdictions, to adopt some form of replacement cost methodology as the chief basis for the valuation of non current property plant and equipment assets. This decision has been strongly supported by its proponents, on the grounds that it results in a degree of comparability which could not be guaranteed prior to the adoption of replacement cost valuation as the primary means of asset value appraisal, and that more importantly, it represents a better measure of asset value since it provides more accurate signals than historical cost based balance sheets as to the level of resources required to be deployed in order simply to maintain existing operating capacity.

The extent to which current or replacement cost valuation techniques have been adopted by the public sectors of a variety of Australian jurisdictions has recently been usefully catalogued, albeit at a high level of aggregation [12]. The research which has been conducted into the phenomenon clearly demonstrates a widespread use of these techniques across the Australian public sector, and a high degree of standardization of valuation and measurement frameworks. The three largest jurisdictions, the Commonwealth, New South Wales and Victoria each use current or replacement cost accounting extensively.

Other jurisdictions have followed this pattern, with some of the smaller jurisdictions, notably Western Australia, being early and radical adopters of new financial management and reporting techniques. While the extent and unanimity of this change in reporting and measurement processes throughout Australia is itself worthy of note, the financial materiality of these changes is a separate and useful indicator of the magnitude of changes involved. This has been examined by Carlin [13], who reports that while the adoption and financial impact of replacement cost approaches to asset valuation has indeed been widespread in the Australian public sector (as measured in terms of increases to depreciation charges, increases in total asset values over the period since the technique was introduced, and the magnitude of asset revaluation reserves as proportions of total and net public sector assets on a jurisdiction by jurisdiction basis), the same cannot be said for private sector reporting entities.

Thus the introduction of replacement cost accounting, part of the overall thrust of accrual based financial accounting and reporting into the public sector, was a factor which significantly reduced the overall comparability of public sector financial statements with those produced by private sector entities, even though at first blush, the common use of accrual accounting by both sectors may have given the opposite appearance.

The impact in a decision setting of the inconsistencies set out above may well have been major, particularly in those jurisdictions in which a capital charging regime has also been implemented. There, government entities are charged a pre-set rate of return on capital, typically levied as a percentage of net assets or of the written down value of the entity's non current property plant and equipment assets [14]. Where asset values have been inflated relative to their historical costs, the likelihood is that the total apparent expense base of government entities will also be inflated, due in part to increased depreciation charges, but also due to additional capital charges which vary as a direct function of assessed asset values [15].

The overall result is that, compared with a private sector entity of equivalent size and undertaking equivalent functions, the cost base of the public sector entity, after the application of replacement cost accounting, higher depreciation and capital charges may well be significantly higher, not as a result of operational differences, but rather, as the result of the application of differential accounting and financial reporting techniques.

4. Incentives for Creative Accounting in Public Sector Settings

The argument that individual public sector agencies would wish their financial position and performance to be portrayed as relatively poorer than that of comparable private sector agencies is unlikely to be highly persuasive. What would motivate such a desire on the part of individual agencies – or the actors within them?

On the other hand, it may well be that significant benefits could accrue to actors other than operating agencies themselves. The adoption of optimal capital structures, replacement cost valuation and capital charging has not been a random phenomenon. Rather, it has been highly systematic and centrally directed. The scriptwriters for this collectively enforced action have been the central financial agencies in a variety of jurisdictions – that is, the treasuries and departments of finance. Interestingly, these organisations are best characterised as principals rather than agents, yet it is they who have demanded that individual line departments (their agents in the production of government goods and services) have implemented accounting and financial reporting practices which, when compared against private sector norms, demonstrate a clear capacity to materially bias cost structures upwards and thus by extension bias decisions made with respect to the locus of production of goods and services.

This point is best contextualised by reference to the strong political preference for the consummation of outsourcing arrangements which has existed in several Australian jurisdictions for the past decade. While political desire to see such arrangements put into place is important in itself, political will coupled with the apparently irrefutable logic of objectified accounting numbers heightens both impetus and legitimacy considerably. Thus it is argued that it is entirely possible that a key rationale for the adoption of unusual, creative and radical accounting and financial reporting techniques in the public sector has been as a cloak to enhance the legitimacy of the politically motivated aspirations of key principals, rather than as some form of utility maximising behaviour by rational agents. It is in this sense that the onus suggested by the typical principal / agent story of behaviour appears to have been reversed in this institutional setting. This also suggests the possibility of other similar reversals in similar and dissimilar institutional settings, but that is a matter beyond the scope of this paper.

5. Conclusion

This paper has argued that although creative accounting has been recognised to be a problem in private sector settings, the public sector, under certain conditions can be a host for the phenomenon. Where this is so, there is a chance that the locus of the incentive to engage in such activities may lie with the principals to public sector agency relationships, rather than with the agents, as is typically hypothesised to be the case. This fact may result in a far more systematic form of "creativity" being observed within a public sector setting than is observable on an entity by entity basis within the private sector, and gives rise to the conclusion that the chief obfusctative effects lie not in relation to public sector to public sector entity comparisons, but rather, in the instance of public to private sector comparisons and resource allocation decisions. This is a matter ripe for an extensive future research agenda.

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