

External Audit Procedures and Their Effectiveness in Detecting the Practice of Creative Accounting: An analytic Study in the Iraqi Environment

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Abstract

The study aims to identify the deceptive methods that used by firms in misleading financial statements and show the role of auditors in detecting the illegal behavior of firms which listed in Iraq Stock Exchange. In addition the study try to shed light on the influence of the deterrence's penalties against companies apply creative accounting. The hypothesis of the study focused on: active role of auditors in reducing creative accounting practices in the financial statements for the companies worked in Iraqi markets. The study includes 13 companies as a sample listed in Iraqi Stock Exchange. According to Miller mathematical scale , the study concludes that studied companies have practiced improper accounting methods for the period (2012 to 2017). In addition it recommends that companies must be obliged to comply with the contents of international standard No. (1), the presentation of financial statements and the local accounting rule No. (6) and on the disclosure of information related to data and financial policies in paragraph (9/ Basic Principles and Provisions) ,which indicated to the need to exercise accuracy and caution when preparing financial statements and disclosing information related to them, but not to justify the formation of secret or undisclosed precautions.

Keywords: Creativity - Creative Accounting, External Audit Procedures.

Introduction

creative accounting has occupied a great importance in the economic domain now days. It has a great impact on achieving the needs of financial statements analyzer, and to identify the reality of the actual performance of the audit committees forming in Iraqi companies and their effectiveness in reducing improper accounting practices. As it known, Iraqi constitutes has shortcomings in legislation, laws and professional instructions for auditing. Thus, it is recommended to find out these committees and determining the criteria for selecting their members, authorities and tasks which they should carry out.

1- Literature Review

1-1 Concept of Creativity

(Koontz et al., 1988: 401) defines creativity as an applying of new ideas in real word. Whereas(Konter ,1998:169) refers to creativity as creating of new ideas and investing them in satisfying human needs. (Heap, 1989: 7) clarify creativity as the

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process of creating a new form or characteristics of a product. hence, the researcher point of view is creativity an activity that leads to a production characterized by novelty, originality and value for the benefit of society.

1.2 Concept of Creative Accounting

(Healy & Wahlen, 1992:56) define the creative accounting as the use of accountant's manager their judgments as well as estimation in a financial reporting and structuring transactions in order to change financial reports, either with the intention of misleading some shareholders about the company's economic performance or to influence the contractual results that are adopted. (Mulford & Comiskey, 2002:3) refer to the game of accounting numbers may pave the way to communicate with investors by showing the company that it has the ability to earn high profits and therefore this helps to increase stock prices.(Brown, 2002: 1) states that " It has become clear that those who manipulate the numbers are trying to show the company's financial position in a more user-acceptable way (this is called creative accounting), and it is trying to change perceptions of the company's performance".

1-3 Emerge of Creative Accounting

For it first arising, creative accounting includes accounting principles and methods to identify changes in the economic, social, political and business matters. mostly the expression refers to the negative sense. it could use in positive way by creating something new or when refine the accounting system to be as extra treasury of accounting information. However, it may appear as undesirable behavior when utilize creative accounting immorality in the firm accounting system. The accumulated experiences has demonstrated, in the most cases, it is used in an unacceptable manner to attract investors by providing fraudulent conditions and sometimes by misleading financial information for economic units. Thus, for the most economists called "accounting deception" Accordingly, there are two identified perspective. The first determines the real changes in the practice of business. The second refers to Decoration, redecorating and interface or what is called "Window dressing". It is unacceptable and lead to a change the realities of the financial information. The second is the so-called Creative Accounting (Sen and Inanga, 2006: 3). For Alam (1988: 5), creative accounting Engages with many acts such as creating information, redecorating documents and forgery the records.

In a study presented by Sen and Inanga to poll opinion on creative accounting, they concluded that it follows accounting methods that distort financial information by using process of "window dressing". The purpose of such manipulations is for giving a theoretical impact of a better financial situation by either increasing or reducing profits as well as by giving a misleading amount to the capital by hiding the required information about existing or potential investors (Sen and Inamga, 2006: 4).

It is noted that there is a broad behavioral or subjective orientation on the part of auditors at all levels (These reasons were the causes that leads to collapse Enron Company) which in turn will harm the successful practical application of ethical principles defined by their institutions. Moreover, selfish behavior driven by self-interest will put the interests of the individual ahead of any other considerations, and examples of such conduct will involve accept the pressure from the company's management to accept the interpretation of indefensible or justified accounting rosters . Similarly, the failure to search for proof evidence as seriously as possible, and to devote less time than is acceptable to the audit (Gowthorpe et al., 1998: 141).

1.4 The Effect of Creative Accounting Practices on the Financial Statements

There are many practices of Creative accounting that can be used (Michael & Hendrikson, 1992:32) According to the following:

- 1- The revenue of the business transaction is quickly recorded. while the sale transaction still in process according to the rules; the income registration is made after the exchange of benefits is completed, and in this way the income generated by the sale is recognized by accounting and written form before the process itself is completed on the real ground.
- 2- The unreal increasing in firm's expenses to reduce visible and taxable profits. In addition, transfer expenses that date back to previous or future years to the current year for the purpose of amplification of the expense aspect with expenses not related to the company's activity for the current year to reduce the pure profit and then reduce the amount of tax calculated on it.
- 3- Many taxpayers do tax evasion by increasing their expenses and expenditures which will reduce their revenues and profits. As an example, the taxpayers declare high salaries and wages for the workers and employees who work for them and these declared salaries do not constitute the truth. By contrast, these taxpayers declare low salaries for their workers and employees when these salaries and wages are taxed for workers, and here they do so in order to evade or reduce tax payments.
- 4- Fixed assets where the historical cost principle is not adhered to in determining the value included in the budget, as well as the customary extinction ratios of assets are manipulated by reducing or increasing them from those used. In this regard, the management's intervention in manipulation or the use of creative accounting in calculating extinction by estimating the productive age of the asset, estimating the value of debris or choosing the method of extinction (Al-ubedi,2008:92).
- 5- Intangible assets are overvalued as intangible asset items, such as trademarks, as well as accounting recognition of intangible assets, are overvalued, contrary to the assets and rules set out in international accounting standards such as recognition of the un-purchased shop's reputation.
- 6- Current investments where manipulation is done in market prices that used to evaluate the stock portfolio, as well as unjustified reductions in low prices allocations
- 7- Cash manipulation where manipulation is done by Concealment the restricted cash items, and to manipulate the exchange rates used in the translation of available foreign exchange cash items.
- 8- Current liabilities, such as the non-inclusion of long-term loan premiums during the current year, in order to improve financial liquidity ratios.
- 9- Inventory, in this item, manipulations and the practice of creative accounting methods are concentrated in the inclusion of inventory statements of stagnant and outdated items of goods, as well as manipulations of their valuation prices and unjustified changes in inventory pricing methods (Kieso et.al.,2008:172).
- 10- Manipulation may lay in the classification of flows between operational investment and financing cash flows , such as the practices of manipulating the classification of the cash flow list, the sale of debit accounts as operating cash flows, even though they are considered financing cash flows such as loans.
- 11- Manipulation of accounting policies used and practiced without exceeding the standards and accounting principles generally accepted, but by exploiting elements of flexibility and choice in those standards and principles. The flexibility of the accounting methods provide opportunities for manipulation and show an image is real result of corporate activity. As examples of such methods are change the method of accounting for long-term investments from the cost method to the property rights method, failure to adhere to the principle of historical cost, re-evaluation of fixed assets at market value and showing surplus in the income list rather than property rights. In addition, the

inclusion of gains or losses of exchange rate fluctuations in the property rights rather than the income statement or by reducing the gains of the sale of investments from the pure income in order to reduce tax effects from operating cash flows (Abu Tamam,2013:65-66) .

As a researcher, I believe that companies may do the creative accounting methods in the income list by different ways to manipulate the level of income differently. As deceptive steps, there is operating income and income before taxes, pure income, and the process of reclassification that shows some elements in the wrong place. Companies can put in the income list an operational expense that is in fact non-operational, does not relate to the company's activity, and therefore falls from the real income. Thus, it has an impact on the pure taxable profit.

1.5 An audit procedure

1- A sufficient understanding of the nature of the client's work in terms of the legal entity, knowledge of the type of activity, organizational structure and accounting systems. Auditor, in light of this information, should accept the task of auditing process or apologize for it.

2- An adequate understanding of the components of internal control systems available to the client include his understanding of the environment of internal control systems (the mechanism of accounting systems used), and the procedures of internal control systems. In addition, know the extent to which they are put into practice and through which it determines whether the client's accounts can be audited or not.

3-Evaluation of the degree of risk in internal control systems.it is noticed that the risk of auditing will be high if the degree of risk is high in detecting internal control systems automatically for the material things that have been shown incorrectly in the final statements.

4- experimental audit where the auditor uses his assessment of internal control systems and his opinion to the degree of risk of audit in determining the nature of the audit work(Timing of audits, time required for audits and sample size).

5- Evaluating the results of the audit work, after the auditor in the audit work decided to do evaluate the results of the audit work and the conclusions that came out. The purpose of such procedure is to find out the extent to which a reliable base can be available to express his opinion on the final accounting statements.

6- The auditor's report, in which he shows the scope of his work and shows the auditor's conclusions regarding to the fairness of the final accounts of each financial center and the results of the work of the institution under scrutiny(Abu Tamam,2013:23).

1.6 The Auditor's Responsibility to Detect Manipulation and Fraud in Financial Statements

Financial statements are prepared by administration in accordance with the established accounting principles. The information contained in these lists must be reliable and appropriate and to truly and fairly reflect the economic situation in which the economic unit operates. These lists cannot be accepted or approved unless they are checked out by an auditor who must express his opinion on them by including notes and clarifications obtained through the analytical tests to those statements. The auditor's responsibility is an important professional legal responsibility that affects many segments of society that rely on the auditors' opinions in check the financial statements. Article 137 of the Companies Act No. (21) of 1997 stipulates that the auditor's responsibility for the validity of the data contained in his report as an agent of the company in the control and audit of its accounts. Also, article 38 of the Rules of Professional Conduct issued by the Association of Accountants and Auditors in 1983 explained that the auditor's responsibility lay in check parties benefiting from the financial statements of the companies he has audited(Hassan 2017:89).

Based on the foregoing, the researcher considers that the responsibility assigned to the auditor in detecting illegal conduct in financial statements is to exert the necessary professional attention. He should refer in his report to the creative accounting practices. The auditor must reveal the amount of its impact on the fairness and validity of the financial statements. Thus, his opinion will be a reflection to the real situation of the company.

2-The Creative Accounting Practices

2.1 Determination of Creative Accounting Practices in the Sectors of Banking and Insurance

Specific samples have been chosen from some companies from sectors of banking and insurance. These companies were listed on the Iraqi Stock Exchange and consisting of (10) banks out of (24) banks, and (3) companies from the insurance sector out of (5) companies. A mathematical model was used in measuring the improper accounting practices, which is the index model (Miller,2009), to determine which of the research-appointed companies is doing improper accounting practices for the period from 2012 to 2017.

The following equation is used :

$$\text{Miller ratio} = \frac{\text{changing in pure working capital}}{\text{cash flows from operational activities}}$$

The Miller model can be formulated in the following equation:

$$\text{Miller Ratio} = \Delta\text{WC} / \text{CFO}$$

ΔWC = change in net working capital.

CFO = cash flows from operational activities .

By comparing the current year's ratio with the same ratio for the previous year, we can conclude two possibilities. The first is the result is equal to zero which means that the company did not practice the improper creative accounting practices in its financial statements .The second is the result is not equal to zero (negative or positive) which means that the company is manipulative with financial statements .

In the absence of improper accounting practices, the following formula is:

$$(\Delta\text{WC} / \text{CFO})_{t0} - (\Delta\text{WC} / \text{CFO})_{t1} = 0$$

In the appearance of improper accounting practices, the following formula is:

$$(\Delta\text{WC} / \text{CFO})_{t0} - (\Delta\text{WC} / \text{CFO})_{t1} \neq 0$$

2.2 Measuring Creative Accounting Practices in the Banking and Insurance Sectors

The practice of creative accounting in the banking and insurance sectors can be measured in the sample of research through the following tables:

Table (1) Measuring creative accounting practices in the banking and insurance sectors for 2013

No.	Companies	Sectors	Miller Index for the current year 2013	Miller Index for the previous year 2012	Measurement of improper accounting practices	Nature of Practice
1	Elaf Al-Islami	Banks	(0.6408)	(0.1895)	0.8303)	Negative
2	Dar AL- Salaam For Investment	Banks	(1.2354)	(0.1804)	(1.4158)	Negative
3	North Bank for Finance and Investment	Banks	(1.7146)	(0.0131)	(1.7015)	Negative
4	Tigris and Euphrates Bank For Development and Investment	Banks	(0.1307)	1.6024	1.4717	Positive
5	United Bank For Investment	Banks	(0.2360)	(0.3100)	(0.5460)	Negative
6	Ashur International for Investment	Banks	(1.1925)	(2.9695)	(1.7770)	Negative
7	Gulf Commercial Bank	Banks	(5.66)	1.01	(4.65)	Negative
8	Elahli Iraqi Bank	Banks	0.074	(0.321)	(0.247)	Negative
9	Iraqi Islamic Bank	Banks	3.19	6.79	9.98	Positive
10	Iraqi Middle East Bank	Banks	(0.004)	0.467	0.463	Positive
11	Gulf For Insuran	Insurance	(0.0811)	(0.2792)	(0.1981)	Negative
12	Al-Ameen For Insurance	Insurance	(1.2899)	(0.7514)	0.5385	positive
13	Elahli For Insurance	Insurance	(1.4914)	(2.5658)	(1.0744)	Negative

Table (2) Measuring creative accounting practices in the banking and insurance sectors for 2014

No.	Companies	Sector	Miller Index for the current year 2014	Miller Index for the previous year 2013	Measurement of improper accounting practices	Nature of Practice
1	Elaf Al-Islami	Banks	0.773	(0.6408)	0.1322	Positive
2	Dar AL- Salaam For Investment	Banks	(0.0017)	(1.2354)	(1.6425)	Negative
3	North Bank for Finance and Investment	Banks	(0.441)	(1.7146)	(2.1556)	Negative
4	Tigris and Euphrates Bank For Development and Investment	Banks	(0.001)	(0.1307)	(0.1317)	Negative
5	United Bank For Investment	Banks	(0.254)	(0.2360)	(0.49)	Negative
6	Ashur International for Investment	Banks	(2.57)	1.1925	(1.3775)	Negative
7	Gulf Commercial Bank	Banks	1.64	) (5.66	(4.02)	Negative
8	Elahli Iraqi Bank	Banks	(2.99)	0.074	(2.916)	Negative
9	Iraqi Islamic Bank	Banks	(2.70)	3.19	0.49	Positive
10	Iraqi Middle East Bank	Banks	(1.35)	(0.004)	1.354	Negative
11	Gulf For Insurance	Insurance	(0.018)	0.0811	0.0631	Positive
12	Al-Ameen For Insurance	Insurance	0.005	1.2899	1.2949	Positive
13	Elahli For Insurance	Insurance	(1.1)	1.4914	0.3914	Positive

Table (3) Measuring creative accounting practices in the banking and insurance sectors for 2015

No.	Companies	Sector	Miller Index for the current year 2015	Miller Index for the previous year 2014	Measurement of improper accounting practices	Nature of Practice
1	Elaf Al-Islami	Banks	0.913	0.773	1.686	Positive
2	Dar AL- Salaam For Investment	Banks	0.545	(0.0017)	0.5433	Positive
3	North Bank for Finance and Investment	Banks	0.001	(0.441)	(0.44)	Negative
4	Tigris and Euphrates Bank For Development and Investment	Banks	0.673	(0.001)	0.672	Positive
5	United Bank For Investment	Banks	0.058	(0.254)	) (0.196	Negative
6	Ashur International for Investment	Banks	0.019	(2.57)	551)	Negative
7	Gulf Commercial Bank	Banks	2.013	1.64	3.653	Negative
8	Elahli Iraqi Bank	Banks	0.106	(2.99)	(2.884)	Positive
9	Iraqi Islamic Bank	Banks	0.249	(2.70)	(2.451)	Negative
10	Iraqi Middle East Bank	Banks	2.248	(1.35)	0.898	Negative
11	Gulf For Insurance	Insurance	0.399	(0.018)	0.3972	Positive
12	Al-Ameen For Insurance	Insurance	0.028	0.005	0.033	Positive
13	Elahli For Insurance	Insurance	0.846	(1.1)	(0.254)	Negative

Table (4) Measuring creative accounting practices in the banking and insurance sectors for 2016

No.	Companies	Sector	Miller Index for the current year 2016	Miller Index for the previous year 2015	Measurement of improper accounting practices	Nature of Practice
1	Elaf Al-Islami	Banks	) (0.083	0.545	0.087	Positive
2	Dar AL- Salaam For Investment	Banks	0.087	0.001	(0.115)	Positive
3	North Bank for Finance and Investment	Banks	(0.115)	0.673	(3.47)	Negative
4	Tigris and Euphrates Bank For Development and Investment	Banks	(3.47)	0.058	(0.026)	Negative
5	United Bank For Investment	Banks	(0.026)	0.019	(1.174	Positive
6	Ashur International for Investment	Banks	(1.174	2.013	(0.480)	Negative
7	Gulf Commercial Bank	Banks	(0.480)	0.106	5.11	Positive
8	Elahli Iraqi Bank	Banks	5.11	0.249	7.11	Positive
9	Iraqi Islamic Bank	Banks	7.11	2.248	(5.92)	Positive
10	Iraqi Middle East Bank	Banks	(5.92)	0.399	(0.285)	Negative
11	Gulf For Insurance	Insurance	(0.28)	0.028	5.60	Negative
12	Al-Ameen For Insurance	Insurance	5.60	0.846	(0.197)	Positive
13	Elahli For Insurance	Insurance	(0.197)	0.846	0.649	Positive

Table (5) Measuring creative accounting practices in the banking and insurance sectors for 2017

No.	Companies	Sector	Miller Index for the current year 2017	Miller Index for the previous year 2016	Measurement of improper accounting practices	Nature of Practice
1	Elaf Al-Islami	Banks	(0.678)	)0.083	(0.761)	Negative
2	Dar AL- Salaam For Investment	Banks	) (2.70	0.087	(2.613)	Negative
3	North Bank for Finance and Investment	Banks	(0.386)	(0.115)	(0.501)	Negative
4	Tigris and Euphrates Bank For Development and Investment	Banks	(0.306)	(3.47)	(3.776)	Negative
5	United Bank For Investment	Banks	(1.01)	(0.026)	(1.036)	Negative
6	Ashur International for Investment	Banks	(9.269)	(1.174	(10.443)	Negative
7	Gulf Commercial Bank	Banks	(0.220)	(0.480)	(0.7)	Negative
8	Elahli Iraqi Bank	Banks	5.6	5.11	10.71	Positive
9	Iraqi Islamic Bank	Banks	7.26	7.11	11.37	Positive
10	Iraqi Middle East Bank	Banks	4.26	(5.92	(1.66)	Negative
11	Gulf For Insurance	Insurance	)5.314(	)0.285(	(5.99)	Negative
12	Al-Ameen For Insurance	Insurance	(4.47)	5.60	1.13	Positive
13	Elahli For Insurance	Insurance	(2.78)	(0.197)	(2.977)	Negative

It was noted that the role of the most committees in banks (formation of committees, the functions and responsibilities of audit committees, the independence of their members, the relationship with the internal auditor, the relationship with the external auditor and the meetings of committees in the sectors of banking and insurance) is still considered formal or symbolic. It is noticed that, they did not perform its tasks and its specific terms of reference in accordance with the law or the instructions, and did not conduct any supervisory activity on the activities of banks. This may be due to the novelty of the legislation where this committee formed to meet the requirements of the Banking Law No. (94) for 2004. As well as the lack of knowledge of bank officials about the importance of the tasks that these committees. The formality and

nominal of these committees may be due to the failure of legislation and public bodies to deal with the outcomes of these committees.

Another vital problem lays in the fact that there are no members of the audit committees currently formed in banks who are specialized in accounting or financial disciplines . As a requirement, it is important to presence of such competencies in the audit committees. As a result, a series of observations have been diagnosed as such:

A- The recommendation of the committees (except the audit committee of Elaf Islamic Bank in 2012) did not notice the nomination of the external auditor and determine his wages in its annual report, although this task is one of the most important work of the audit committees.

B. Most audit committees suffer from problems in the appointment of their members and the performance of their duties. Most member lack the coordination and cooperation between each other and with the internal auditor and external controller as well as with the executive management. in other words , there is no clear and precise definition of their tasks and powers And her responsibilities.

C. These committees did not perform their tasks and responsibilities related to overseeing the financial reporting process, such as reviewing annual financial reports before submitting them to the Board of Directors. In addition, they did not perform the reviewing and examining the impact of the change in accounting policies, and assessing and evaluating fraud cases in financial statements. They did not perform assessing the accounting estimates carried out by the department or examining inventory adjustments and other information contained in the bank's annual report.

D. The boards of directors of the research sample companies which are operating in the insurance and banks sectors did not form audit committees to oversee and control the performance of the executive departments of companies . This may due to The multiplicity of supervisory entities in stock companies in Iraq and their overlap leads to weakness in coordination among them, which reduces the effectiveness of the oversight role and facilitates the process of manipulation by companies. Also, the shortcomings in the Iraqi laws that did not specify the powers, functions and nature of the work of such committees, and the organization of their association with the organizational structure of the company, and the number of its members, qualifications and conditions of independence.

Through the tables (1), (2), (3), (4) and (5) ,it was noted that the banking and insurance sectors used an inappropriate creative accountant in their financial lists. It was noted during the process of checking companies' samples for the banking and insurance sectors, that there is a weakness in the effectiveness of the audit committees formed by the Board of Directors , where this weakness was diagnosed in the outer audit procedures. It is observed that the audit committee formed in the companies sample research listed on the Iraqi Stock Exchange is not active in reducing improper accounting practice, for reasons related to the lack of legislation and laws, and the weak role of Regulatory and supervisory bodies that follow up these laws and instructions. Consequently, this is a proof of the research hypothesis: "There is no active role to the auditors in Iraqi environmental in reducing creative accounting practices in financial statements.

Conclusion

The gaps in internal and external audit policies and the procedures applied to monitor the work of the administration, weakness in the internal control systems of companies, and the ineffectiveness of audit committees are one of the contributing factors to the practice of improper accounting by management. The current study, through the actual reality of the research, and using the mathematical Miller Scale, found that all the research sample companies consisting of (13) companies listed on the Iraqi Stock Exchange with their various sectors (banks and insurance), have practiced improper accounting methods for the period of 2010 until 2017. It has been noted that the role of most audit committees in the

sectors of banking and insurance is formal or symbolic. They did not perform its tasks and competences in accordance with the law or the instructions, and did not conduct any regulatory activity on the activities of banks. It is observed that the audit committee formed in the companies sample research listed on the Iraqi Stock Exchange is not active in reducing improper accounting practice, for reasons related to the lack of legislation and laws, and the weak role of Regulatory and supervisory bodies that follow up these laws and instructions.

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