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## Nexus between Creative Accounting Practices and Financial Statements Quality in Nigeria: A Reflection of Oil Servicing Companies in Port Harcourt Metropolis

**Nangih, Efeeloo (MBA, ACA)**  
Lecturer and Accounts/Tax Consultant  
Department of Accountancy  
Kensarowiwa Polytechnic, Bori  
nangihlah@yahoo.co.uk

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### **Abstract**

*This study examined empirically the influence of creative accounting practices on the quality of financial statements of oil servicing companies in Nigeria. To achieve the objective of the study, three hypotheses were formulated and stated thus: There is no significant relationship between aggressive earnings management and relevance/verification of financial statements, there is no significant relationship between unjustified changes in accounting policies and estimates and comparability/ understandability of financial statements, and there is no significant relationship between profit smoothing and objectivity/faithful representation of financial statements. Survey research design was adopted for the study. Data were collected through well-structured and validated questionnaire and analysed done using ordinary least squares regression technique. Results of the findings revealed that creative accounting practices by oil servicing companies influenced the quality of their financial statements negatively. It was recommended that oil servicing companies in Nigeria should avoid creative accounting practices as they distort the quality of financial statements and by extension the usefulness of financial information passed on to all users.*

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**Keywords:** *Creative Accounting, Financial Statements, Financial Information, Financial Statements' Quality.*

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### **1.0 Introduction**

The accountant is a communicator or simply a reporter of financial transactions. As a communicator, he reports the financial performance, financial position, and changes in cash flows through financial statements to users and stakeholders for decision making. Financial statements, serves as vehicles through which the accountants communicate. Today's financial accounting reports focuses on providing relevant, reliable and timely financial information to stakeholders who use it to make critical financial decisions (Obara & Nangih 2017). Asechemie (2002) argued that financial statements are signposts which direct users on the path of decision making. Such important documents upon which financial decisions are based are expected to be reliable, understandable, comparable transparent and free of bias. Regulators of the accounting profession globally, have made concerted efforts towards accounting standardization geared towards making sure financial statements prepared by entities are fit for purpose and consistent with accounting standards and practices devoid of manipulations. However, preparers of financial statements sometimes deliberately distort information contents financial reports and this has the effect of altering the content of the messages being transmitted. This deliberate and wilful altering of the content of financial statements through the use of lawful accounting policies and methods is termed "creative accounting". Creative accounting therefore, is a form of accounting which, while complying with all regulations; the entity nevertheless gives a biased impression (usually favourable) of

the company's performance and position (Kaplan 2013). Amat & Gowthorpe (2004) sees creative accounting as the transformation of financial accounts using accounting choices, estimates and other practices allowed by accounting regulation. Notable creative accounting practices variously employed by management or preparers include: deliberate non-recognition of liabilities, aggressive earnings management through the recognition of revenue before they are earned, deliberate recognition of unusual assets, unjustified changes to accounting policies and accounting estimates and profit smoothing through the manipulation of profit figure. Overall, the aim of creative accounting practices is usually to suit the purpose of the preparers of financial statements, who attempt to create a view of reality that they wish to communicate to users. By so doing, they undermine the quality and fundamental attributes of such financial statements, which ideally should be reliable, relevant, objective and comparable at all times.

Nyabuti et al (2016), Amat et al (2003), Amat and Caherine G. (2004), Balaciu and Pop (2008), Baralexis (2004); Ezeani et al (2012) and Gosh (2010) have all looked at the concept of creative accounting and its implications on financial performance. Of all these, none has empirically looked at the influence of creative accounting practices on financial statements quality in Nigeria. This forms our point of departure. Thus, this paper attempts to examine the implications of creative accounting practices on the quality of financial statements in Nigeria. The basic questions this study seeks to answer are:

- i. To what extent does aggressive earnings management affect the relevance and verifiability of financial statements?
- ii. To what extent does an unjustified change to accounting policies or accounting estimates affect the comparability and understandability of financial statements?
- iii. To what extent does profit smoothing affect the objectivity and faithful representation of financial statements?

The answer to these questions will help financial information users, particularly the investors and analysts of accounts of oil servicing companies to address the problems associated with creative accounting practices. It will also help regulators to be aware and therefore put in place policies that will prevent wrongful use of creative accounting by preparers.

## **2.0 Literature Review**

### **2.1 The concept of Creative Accounting**

Creative accounting practices are done with the motive of making the financial statements appear better and financially stronger on one hand or financially weaker on the other hand depending on management's desire. Amat and Gowthorpe (2004) used the word creative accounting interchangeably to mean earnings management. They opined that creative accounting means the transformation of financial accounting statements using accounting choices, estimates and other practices allowed by accounting regulations. Ezeani et al (2012) posits that creative accounting was responsible for various financial crises and portends a serious challenge to the accounting profession. They further argued that when creative accounting is done with extreme negative intentions, it affects the credibility of financial statements and decisions of its users. This is because the accounting principles and standards are manipulated to hinder the reliability, objectivity and comparability of such statements. Hence decisions based on such financials may be misleading and faulty. Kamau et al (2012) argued that creative accounting practices are widely practiced among companies. They further stated that tax avoidance and tax evasion were the major cause of creative accounting among entities.

Apart from tax evasion and avoidance reasons, management may have strong reasons and

incentives to present their accounts in the best possible light where (i) the directors want to sell the company in the near future. This they do to make it look attractive to elicit interest and higher valuation, (ii) where the company is experiencing a difficult and bad times such as decreasing profits, possible takeover or decreasing shareholders and investors' confidence (iii) where the manager's remuneration is tight to the profit and (iv) where the company is at the verge of defaulting in its loan covenants.

Creative accounting practices take various forms. Firstly, it may be done in the form of off statement of financial position financing, where transactions are deliberately constructed to allow the non-recognition of assets and particularly liabilities for loans. Secondly, it may be in the form of aggressive earnings management where revenues are being recognised before they are earned by the company. Thirdly, creative accounting could be carried out by way of unjustifiably altering accounting policies or accounting estimates for example, increasing the economic lives of non-currents assets with the aim of reducing their depreciation expenses and increasing earnings and vice versa. Finally, management could embark on the distortion of profit figure by including fictitious assets and liabilities in the accounts and spreading these amounts over time. This is called profit smoothing.

## **2.2 Financial statements Quality**

Users need information to help them assess the performance and position of an entity in order to make useful decisions. They need a credible financial information about the resources of the entity and the claims against the resources to know whether management have performed well in the discharge of their responsibilities. For that, financial statements must have certain fundamental qualities or attributes. These characteristics include: reliability, relevance, faithful representation, understandability, verifiability, and comparability. These are also called fundamental and enhancing characteristics of financial reporting information.

By relevance we mean accounting information must be useful for decision making needs of the users. If accounting information is not relevant though understandable, it will be useless. Information has the quality of relevance when it influences the economic decisions of the users by helping them to evaluate past, present or future events or confirming or correcting their past evaluations. While verifiability entails that financial statements should be verifiable with some original documents (source documents). True position is ascertained if any checking by way of verification is carried on periodically.

By comparability and understandability, we mean financial statements of a business enterprise, must be prepared on a consistent basis and principles as to make comparison of the net results within the enterprise over a period of time possible on one hand; while it should also be simple to understand rather than being ambiguous on the other hand.

By objectivity, information in financial statements must be neutral, that is free from bias. It should be not manipulated or distorted by preparers. It should also faithfully represent the true and fair status of the entity always.

## **2.3 Development of Hypotheses.**

Based on the above literature review and objectives of the study, we formulated the following hypotheses for the study:

**H01:** There is no significant relationship between Aggressive Earnings Management and Financial Statements' Relevance/Verifiability of oil servicing companies in Nigeria.

**H02:** There is no significant relationship between unjustified changes in accounting policies and estimates and financial quality (of comparability and understandability) of oil servicing companies in Nigeria.

**H03:** There is no significant relationship between Profit smoothing and financial statements quality of objectivity and faithful representation of oil servicing companies in Nigeria.

### 3.0 Research Methodology

The researcher adopted the Survey research design for this study. Survey research design was suitable for this study because it intended to cover quite a larger number of samples, but because of time and other constraints, part of the population was used for the study and the findings generalized for the entire population, being the entire of oil servicing companies operating in Nigeria. In all, a total of 160 questionnaires were distributed while 154 were returned. These respondents' opinions were conveniently sampled among staff of 6 major oil servicing companies operating in Port Harcourt namely; Harlibuton Nigeria Ltd, Baker Huges Nigeria Ltd, Proserv Nigeria Ltd, Gramen Petroserv Nigeria Ltd, Union Energy Nigeria Ltd, Global Process and Pipeline Services Ltd, Poseidon Nigeria Ltd, B.G Technical Nigeria Ltd, Oil Test Nigeria Ltd and Oil Data Nigeria Ltd. Data collected were analyzed using ordinary least squares technique using SPSS.

### 4.0 Data Analysis and Discussion of Findings

#### 4.1 Test of hypothesis

**Hypothesis 1:** There is no significant relationship between Aggressive Earnings Management and Financial statements quality (of Relevance and Verifiability) of oil servicing companies in Nigeria. The dependent variable in this hypothesis is financial statement qualities while the independent variable is Aggressive Earnings Management. Ordinary least square multiple regression statistical technique was employed to test this hypothesis. The result is presented in table 4.1 below.

**Table 4.1: Regression results of the relationship between Aggressive Earnings Management and Financial Statement's Quality (Relevance and Verifiability) of Oil Servicing Companies in Nigeria.**

**Dependent variable:** Financial Quality (RELEV, VERIF)

Variable	Estimated Coefficients	Standard Error	T-Statistic	P- Value
(Constant)	-792635.252	385766.073	-2.055	.109
RELEV	-.078	.184	-.426	.692
VERIF	-1.535	.565	-2.717	.053

R = .961

R-Square = .92

Adjusted R-Square = .848

F – Statistic = 12.119 (P-Val= 0.01)

**Source: Computed by SPSS**

The R<sup>2</sup> value of 0.92 in Table 1 shows that about 92 per cent changes in the dependent variable Financial Statements Quality (of relevance and verifiability) of oil servicing companies in Nigeria is caused by changes in the independent variable (Aggressive Earnings Management). This implies that Aggressive Earnings Management is a prime determinant of

distortions of financial statement quality of relevance and verifiability. Also, the adjusted  $R^2$  value of 0.848 means that the model is about 85 per cent well fitted. The F-value of 12.119 which is significant at 0.05 level of significant goes to confirm the fact that Aggressive Earnings Management (as a proxy of creative accounting practice) affects the relevance and verifiability of financial information of oil servicing companies in Nigeria.

The estimated coefficient for relevance/verifiability was negative, implying that there exists an inverse relationship between aggressive earnings management and financial statements quality of relevance and verifiability. The results are all significant at 0.05 level of significance.

**Hypothesis 2:** There is no significant relationship between Unjustified Changes in Accounting Policies and Estimates and financial qualities (of comparability and understandability) of oil servicing companies in Nigeria. The dependent variable in this hypothesis is financial statements quality while the independent variable is Unjustified Changes in Accounting Policies and Estimates. Ordinary least square multiple regression statistical technique was employed to test this hypothesis. The result is presented in Table 4.2.

**Table 4.2: Regression results of the relationship between Unjustified Changes in Accounting Policies and Estimates and Financial Quality (comparability and understandability) of oil servicing companies in Nigeria.**

**Dependent variable:** Financial Quality (COMPB and UNDST)

Variable	Estimated Coefficients	Standard Error	T-Statistic	P- Value
(Constant)	-158583.639	90506.267	-1.752	.140
COMPB	-.076	.043	-.607	.571
UNDST	-.066	.113	-.492	.644
R	= .978			
R-Square	= .956			
Adjusted R-Square	= .922			
F – Statistic	= 27.44 (P-Val= 0.01)			

**Source: Computed by SPSS**

The  $R^2$  value of 0.978 in Table 2 shows that about 98 per cent changes in financial statement's quality of comparability and understandability was caused by changes in unjustified changes in accounting policies and estimates of the companies. That implied that only 2 per cent changes in financial statement quality was caused by other factors not shown in the equation. Thus, unjustified changes in accounting policies and estimates was the prime determinant of financial statements quality distortions. Also, the adjusted  $R^2$  value of 0.956 means that the model is about 96 per cent well fitted. The F-value of 27.44 which is significant at 0.05 level of significant goes to confirm the fact that creative accounting practices (represented by changes in accounting policies and estimates) were prime determinants of distortions in the financial statements quality. The estimated coefficient for comparability and understandability was negative, meaning that there exists an inverse relationship between the dependent and independent variables.

**Hypothesis 3:** There is no significant relationship between Profit smoothing and financial statements quality (of objectivity and faithful representation of financial statements) of oil

servicing companies in Nigeria. The dependent variable in this hypothesis is financial statement quality while the independent variable is profit smoothing. The result is presented in table 4.3.

**Table 4.3: Regression results of the relationship between Profit smoothing and Financial Statement's Quality (Objectivity and Faithful representation) of Oil Servicing Companies in Nigeria.**

**Dependent variable: Financial Quality (OBJEC, FAIRP)**

Variable	Estimated Coefficients	Standard Error	T-Statistic	P- Value
(Constant)	-862635.252	485766.073	-2.055	.109
OBJEC	-.077	.194	-.426	.692
FAIRP	-1.635	.565	-2.717	.053

R = .961  
R-Square = .91  
Adjusted R-Square = .822  
F – Statistic = 14.129 (P-Val= 0.01)

**Source: Computed by SPSS**

The  $R^2$  value of 0.91 in Table 1 shows that about 91 per cent changes in the dependent variable Financial Statements Quality (of objectivity and faithful representation) of oil servicing companies in Nigeria was caused by changes in the independent variable (Profit smoothing). This implies that Income smoothing by the companies is a prime determinant of distortion of financial statement quality in Nigeria. Also, the adjusted  $R^2$  value of 0.822 means that the model was about 82 per cent well fitted. The F-value of 14.129 which is significant at 0.05 level of significant goes to confirm the fact that Profit smoothing affects the objectivity and faithful representation of financial information of oil servicing companies in Nigeria.

The estimated coefficient for objectivity and faithful representation was negative, implying that there exists an inverse relationship between profit smoothing and financial statements quality of objectivity and faithful representation. The results are all significant at 0.05 level of significance.

## 5.0 Conclusion and Recommendations

This study was aimed at investigating the influence of creative accounting practices on financial statements quality of oil servicing companies in Nigeria. The proxies of creative accounting practices (namely aggressive earnings management, deliberate distortion of accounting policies/estimates and profit smoothing) were used as the independent variables whereas the quality of financial statements was used as the dependent variables (indicated by comparability, understandability, faithful representation, objectivity, relevance and reliability; as its proxies). The study concluded that creative accounting practices distorts the financial quality of financial statements and by extension will misinform users in their decision making.

Based on the above findings, the following recommendations were made by the study:

1. Regulators of the accounting profession should reduce the areas allowed for alternatives in the treatment of financial transactions in financial reporting. This is to check or reduce the chances of creative accounting and its negative impacts on

financial reporting in Nigeria.

2. Regulators should also embark on proper enlightenment campaigns to preach against the use of artificial transactions in financial statements to reduce the practice of creative accounting.
3. Preparers of financial statements should be more committed to displaying the agency roles delegated to them by the stakeholders by preparing and presenting financial statements devoid of harmful creative accounting practices.
4. Proper internal control mechanisms should be put in place companies to check the problem of profit smoothing and other creative accounting practices, which had been responsible for several collapses of companies in Nigeria and beyond.
5. There should be increased awareness of the problems of creative accounting in Nigeria among all stakeholders, considering the negative effects on the users and the economy at large.
6. Violators if found guilty should be made to “pay for their sins”. Heavy sanctions should be meted out to those found to be engaging in harmful creating accounting practices to serve as a deterrent to others.
7. The Financial Reporting Council of Nigeria and other regulatory bodies should be more proactive in the discharge of their duties, as this will check will manipulations of financial information by prepares for selfish gains.

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