Relationship between Auditors' Ethical Judgments, Quality of Financial Reporting and Auditors' Attitude towards Creative Accounting: Malaysia Empirical Evidence

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Abstract

The aims of the study are to determine the relationship between auditors' ethical judgments, quality of financial reporting and auditors' attitude towards creative accounting. The respondents of the study are178 auditors in Klang Valley and Selangor. Results indicate that there are significant relationships between auditors' ethical judgments, quality of financial reporting and auditors' attitude towards creative accounting. Moreover, the results also show that there is a significant relationship between auditors' ethical judgments and quality of financial reporting. The results of the study are very important to determine the pattern of Malaysian auditors' attitude towards creative accounting practices via auditing financial reports to complement empirical evidences and literatures in this area by investigating the insights of Malaysian auditors towards creative accounting.

Keywords: ethical judgments, quality of financial reporting, creative accounting

1. Introduction

Creative Accounting (CA) is also known as aggressive accounting, income smoothing and earnings management (Ezeani, Martin, Ezemoyih and Okonye (2012). Ghosh (2010) defined CA as the transformation of accounting figures and the perpetrator taking advantage of the existing rules or ignoring some of the rules. CA is not just not interrupt accounting standard, but it still leads to incorrect information of company that will later mislead investors in judging the performance of the company (Abdul Rahman and Mohamed Ali, 2006). Wider CA practices intrude into manipulation, deceit and misrepresentation of the financial statement. There are many factors which lead the management to be involved in CA practices. Among the factors are analysts' forecast, accesses to debt markets, competition, contractual obligations, roaring stock market, new financial transactions, market disregard of big charges, management compensation, excessive profit followed by fear of decline and concealing unlawful transactions (Duncan, 2001). Other than that, Spohr (2005) also stated that the motivator of carrying out CA practices includes feeling pressured or having an incentive to commit fraud and also perceiving an opportunity to do so.

From the researchers' point of view, it is vital for auditors to have a high level of ethical standard. By having CA in the financial statement, the correct information becomes incorrect information for the purpose of user decision. The users may take an ineffective and inefficient decision because they depend on the manipulated accounting information. Qualified and reliable auditors are needed in this profession to carry out their responsibilities and perform services in the context of serving the public's interest. The public trust the auditors to perform their duties proficiently. Auditors 'thus need to balance competing interests to perform their public service role and understand the role of ethics. Auditors 'however, admitted that they have to maintain the public's confidence in them. If auditors are not ethical, the public will not have confidence in them.

This will affect the economic well-being of the country. Thus, the aims of this study are to determine the relationship between auditors' ethical judgments, quality of financial reporting and auditors' attitude towards CA. The results of the study are very important to determine the pattern of Malaysian auditors' attitude towards CA practices via auditing financial reports to complement empirical evidences and literatures in this area by investigating the insights of Malaysian auditors towards CA.

2. Literature Review and Theoretical Framework

2.1CA Cases in Malaysia

In this section, the researchers discovered two anonymous cases in Malaysia that involved misstatements of financial information in their annual reports that led to investigation bathe Securities Commission Malaysia (SCM) and Malaysia securities market regulator, Bursa Malaysia Berhad (BMB); companies T and M. In May 2007, the special appointed auditor of company T found that the company's revenue for 2005 and 2006 had been overstated by more than MYR 500 million through recognition of revenue that had yet to crystallize. In the financial year ending December 31, 2006, 20 invoices totaling up to MYR 333 million were recorded false. The overstatement of revenue for the financial year ending December 31, 2005, involved the recording of invoices issued for purported services to 19 companies totaling approximately MYR 197 million. A preliminary investigation highlighted on "substantial irregularities" in the subsidiaries' financial statement, including fictitious trade creditors and debtors, undisclosed related party transactions, and a deposit payment of MYR 211 million for production lines that appeared to be fictitious in company M. Misstatements in the balance sheet included inventories, trade receivables, and prepayments that occur in 2005.

It is overwhelming that frauds of this scale went undetected for several years, even though several auditors have probably went through the financial statement. It was concluded that the misstatements in the company's financial statement have been going on and accumulated over a number of years. These two cases demonstrate that the adoption of CA practices can be traced many years before they are detected. Many questions have arisen as to why the previous auditors failed to bring the issue to attention during the routine course of audit of the financial statement. If the audits were conducted with care and consideration and all relevant audit procedures were undertaken, the auditor should have discovered frauds of that magnitude. Nevertheless, this did not happen and stakeholders had to wait for the newly appointed auditor to detect that something is wrong with the company's financial statement and wonder how companies that have creatively manipulated their financial statement to this extent could have deceived previous auditors. Another question of equal importance is whether the auditors are doing their work properly or vice versa.

2.2 Ethical Judgement, Quality of Financial Reporting and Auditors' attitude towards CA

Aw (2006) defined ethics as an inquiry into the nature and background of morality, where the term morality is taken to mean moral judgment, standards and rules of conduct. Ford (2010) defined ethical judgment as a situational ethicist whose work has implications on the ethical issues in professional. Additionally, Barnett (2001) mentioned that the "ethical decision making" is a complex process that is affected by personal, situational and issue-related factors. The moral intensity of ethical issues appears to be a key characteristic of ethical issues that affects decision making (Barnett, 2001). Sparks and Pan (2010) stated that ethical judgments are defined as a behavior or course of action, ethical or unethical that is based on the individual's personal evaluation. Auditor adds more credibility to financial information and financial statement and they serve an active role in reducing the effects of CA (Mohammed and Mohammed, 2013). Interestingly, some people believed that auditors' ethics are more crucial than their competence. They believed that when auditors follow the ethical rules of their profession, they will be able to play a more important role in detecting the different methods of CA practices. Auditors are supposed to be well qualified to practice audit and they should have sufficient knowledge regarding the accounting principles and audit standards, but when they do not employ the ethics of their profession, they will not be able to provide any benefits to the audit profession as a whole, and they will not be able to provide reasonable solutions for the problems of CA. The quality of financial reporting is considered when the information is said to be relevant if the shareholders use it when they want to make a decision towards investment and allow them to use past performance to predict future performance. Rabin (2005) mentioned that an auditor is expected to take into count whether the information presented in financial statement is relevant, reliable, comparable and understandable. Misleading financial reporting will harm the users and public at large, especially the stakeholders on the quality and reliability of information provided in the reports.

Generally, distortion of data in one year often leads to the distortion of data in the next year, and typically, the slump in a bad year will keep on piling onto the coming year and the company will continue to be more tied up to misleading figures, often seemingly devoting more time in the presentation of figures rather than managing the company. Valentin, Mioara and Alina (2010) stated that the accounting profession's objectives are established to meet the highest standards of professionalism in order to achieve the highest levels of performance to meet the public interest. Mele' (2005) highlighted that good behavior requires deliberation and deciding to carry out an action and practical wisdom plays a crucial role, such as objectivity, open-mindedness, insight and perspicacity that can be considered as integrated within practical wisdom. Mele' (2005) also stated that moral motivation as such person understood and willingness to take the moral course of action, placing moral values (human goods) above other values and taking personal responsibility for moral outcomes.

2.3 Theoretical Framework and Hypotheses Development

A major theoretical premise underpinned in this study is to determine the relationship between auditors' ethical judgment, quality of financial reporting and auditors' attitude towards CA. This study referred to and adopted the theoretical framework by Rabin (2005) in the study of investigation of auditors' perception in South Africa. Figure1 presents the three variables of the study. The dependent variable is the auditors' attitude towards CA whereas the two independent variables are the auditors' ethical judgments and quality of financial reporting. Rabin (2005) found that there is no significant relationship between auditors' ethical judgment and auditors' attitude towards CA. However, Mohammed and Mohammed (2013) revealed that the auditors have more integrity and they are more objective, as their ability to detect CA practices increases. On the other hand, Rabin (2005) also found that there is a positive significant relationship between the qualities of financial reporting and auditors' attitude towards CA. Thus, the following hypotheses have been developed:

H1: There is a significant relationship between auditors' ethical judgment and auditors' attitude towards CA.
H2: There is a significant relationship between quality of financial reporting and auditors' attitude towards CA.

3. Research Methodology

3.1 Sample and Instrument

The sample of the study comprises of178 respondents, among auditors in Klang Valley and Selangor, six from the Big Four and the balance comes from small medium enterprises. The instrument is adopted from Rabin (2005) in the study of auditors' attitude towards CA in South Africa. The survey consists of cover letter, background of the respondents in part A, six items on auditors' ethical judgments in part B, six items on the quality of financial reporting in part C and eight items on auditors' attitude towards CA in part D. There are six items on the background of respondents including gender, race, religion, age, basic salary and working experience. The Likert scale from one to five in which one presents Strongly Disagree (SD) and five indicates Strongly Agree (SA) are adopted in parts B, C, and D. Permission was obtained from the management of the firm by an official letter via email and postal. Figure 2 presents the measurement of variables.

4. Results and Discussion

Table 1 presents the demographic profile of respondents, 42.7% were male and 53.7% for female. As for the race, the percentage of Malays is 60.7% while 39.3% of respondents are non-Malay. Based on religion, 61.2% are Muslims whereas 38.8% are non-Muslims. The highest age group is from the range of between 21 – 30 years old with a percentage of 51.1%, followed by a range of between 31 – 40 years old with a percentage of 29.2%. According to the salary level, the highest is 44.9% which is within the range of between RM1, 500and RM 3,000. The highest frequency of working experience is 35.4% from the range of between three to four years.

Table 2 reveals the descriptive analysis of all items in the survey. There are six items to represent the auditors' ethical judgements in Panel A but the italic and grey highlighted items will not be taken as part of this variable because the means of these variables are in the range of neutral where respondents could not determine their views on these items. Thus, only two items will represent the auditors' ethical judgements. This also applies to Panel C, where only one item will be considered to represent the auditors' attitude towards CA. Researchers also went through the internal consistency procedures where the Cronbach Alpha (CA) of auditors' ethical judgements is 0.824 (two items), quality of financial reporting is 0.821 (six items) and auditors' attitude towards CA is 0.840 (seven items). Researchers found that all variables are not normally distributed after running through the Kolmogorov-Smirnov tests in which the significant level of all variables are less than $p < 0.05$.

Thus, the researchers proceeded to non-parametric analyses to test the hypotheses. Table 3demonstratesthe Spearman's Rho correlation results. EJ represents the auditors' ethical judgments, QOFR represents the Quality of financial reporting and Attitudes represents the auditors' attitude towards CA. Results show that there is a positive significant relationship between EJ and Attitudes with correlation coefficient $r=0.559$, $p<0.05$, significant at the 0.01 level (2-tailed);there is a positive significant relationship between QOFR and Attitudes with correlation coefficient $r = 0.594$, $p < 0.05$, significant at the 0.01 level(2-tailed) and there is a positive significant relationship between EJ and QOFR with correlation coefficient $r = 0.400$, $p < 0.05$, significant at the 0.01 level (2-tailed).Strong relationships occur between EJ, QOFR and Attitudes and medium relationship can be seen between EJ and QOFR. To conclude, the researchers accepted the two following hypotheses:

H1: There is a significant relationship between auditors' ethical judgment and auditors' attitude towards CA.
H2: There is a significant relationship between quality of financial reporting and auditors' attitude towards CA.

H1 result shows the inconsistency with Rabin (2005) where he found that there is no significant relationship between EJ and auditors' attitude towards CA. This may be due to different cultures and mindsets between auditors in South Africa and Malaysia. Malaysian auditors perceived that when the auditors' ethical judgment exists, it will relate to the auditors' attitude towards CA. On the other hand, the researchers also support the recommendation by Au and Wong (2000), Jadallah and Dehni, (2008), Fan (2008) and Karacaer, Gohar, Aygun and Sayin (2009) where they revealed that personal values may influence decision making judgment in business and organizational contexts. Thus, it is proposed that the greater the auditors' personal values are, the more likely they will form ethical judgments. Furthermore, the researchers also support the recommendation by Barnett (2001) who found that the moral intensity of ethical issues appears to be a key characteristic of ethical issues that affects decision making and auditors play an active role in reducing the effects of CA (Mohammed and Mohammed, 2013).H2 result however, reflects the consistency with Rabin (2005). Researchers agreed with Rabin (2005) who mentioned that an auditor is expected to take into count whether the information presented in financial statement is relevant, reliable, comparable and understandable, or vice versa.

5. Conclusion

The aim of the study is to determine the relationship between EJ, QOFR and auditors' attitude towards CA. The respondents of the study consist of 178 auditors in Klang Valley and Selangor. Two hypotheses have been tested in this study and the researchers accepted both hypotheses. Only H1 is inconsistent with Rabin (2005) and the researchers are in opinion that the matter occurs due to different cultures and mindsets of auditors in perceiving CA between two countries; South Africa and Malaysia. The limitation of the study includes the limited number of respondents where they (auditors) are not so entertained type of respondents, close-minded and not welcoming. Future researches could be extended to other states of Malaysia, so that it will give some reviews about auditors' perceived in Malaysia. Other than that, the study about CA should give a better impact to others. Auditors should be required to prepare, in addition to the normal attestation, a quality of earnings report on the income statement. This will assist auditors to pay particular attention in identifying earnings management schemes by companies. The accounting profession should strengthen its ethical code so that the individual accountant or auditor will be less willing to connive on CA. This has become imperative in view of the ethical challenges of the accounting profession posed by CA resulting from the enormous scope for abuse of accounting policy choice, judgment and assumptions about the future and reclassification and presentation of financial numbers in the financial statement.

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Figure 1: Theoretical Framework

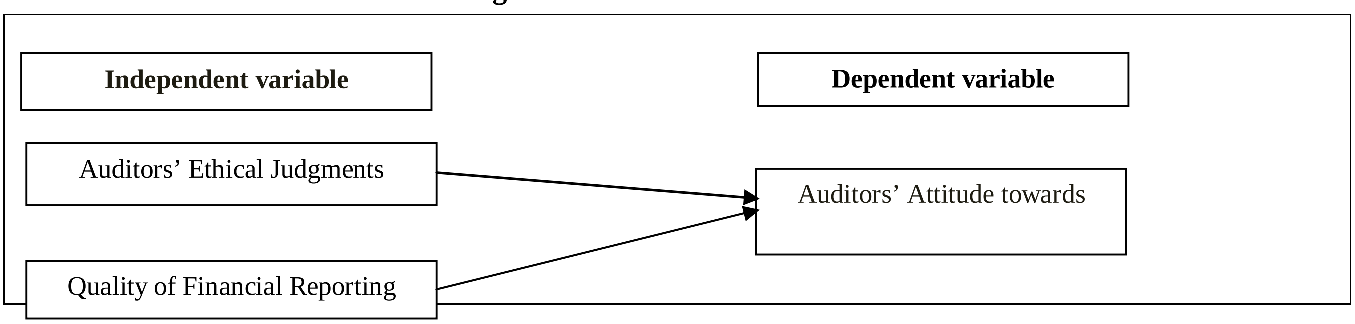

Figure 2: Measurement of variables

Variable	**Measurement**
Gender	1= Male, 2= Female
Race	1= Malay, 2= Chinese, 3= Indian, 4= Other
Religion	1= Islam, 2= Christian, 3= Hindu, 4= Buddha, 5= Others
Age	1= Below 20, 2= 20-30, 3= 31-40, 4= 41-50, 5= 51 Above
Basic salaries	1= Below 1500, 2= 1500-3000, 3= 3000-4500, 4= 4500-6000, 5= Above 6000
Working Experiences	1= 0-2 Years, 2= 2-4 Years, 3= 4-6 Years, 4= 6-8 Years, 5= 8 Years and Above
Ethical Judgments Quality of Financial Reporting Auditors' Attitude towards CA	1=Strongly Disagree, 2=Disagree, 3=Neither Disagree or Agree, 4=Agree, 5=Strongly Agree

Table 1: Demographic of Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Gender	Male	76	42.7	42.7	42.7
	Female	102	57.3	57.3	100.0
	Total	178	100.0	100.0	
Race	Malay	108	60.7	60.7	60.7
	Chinese	57	32.0	32.0	92.7
	Indian	12	6.7	6.7	99.4
	Others	1	.6	.6	100.0
	Total	178	100.0	100.0	
Religion	Islam	109	61.2	61.2	61.2
	Buddhism	30	16.9	16.9	78.1
	Christianity	31	17.4	17.4	95.5
	Hinduism	8	4.5	4.5	100.0
	Total	178	100.0	100.0	
Age	20	12	6.7	6.7	6.7
	21-30	91	51.1	51.1	57.9
	31-40	52	29.2	29.2	87.1
	41-50	19	10.7	10.7	97.8
	51 Above	4	2.2	2.2	100.0
	Total	178	100.0	100.0	
Salary	1500-3000	80	44.9	44.9	44.9
	3001-4500	50	28.1	28.1	73.0
	4501-6000	30	16.9	16.9	89.9
	Above 6000	18	10.1	10.1	100.0
	Total	178	100.0	100.0	
Working Experiences	0-2 Years	51	28.7	28.7	28.7
	3-4 Years	63	35.4	35.4	64.0
	5-6 Years	30	16.9	16.9	80.9
	7-8 Years	18	10.1	10.1	91.0
	8 Years and Above	16	9.0	9.0	100.0
	Total	178	100.0	100.0	

Table 2: Descriptive Analysis

	N	Minimum	Maximum	Mean	Std. Deviation
Panel A: Auditors' ethical judgements					
Breaking confidence of the client's employees	178	1	5	2.46	1.198
Taking a client to lunch in appreciation of introduction	178	1	5	2.52	1.146
Decreasing fees to attract new clients	178	1	5	2.57	1.293
Warning client of the debtor's bankruptcy	178	1	5	2.80	1.241
Accepting an audit where auditor had been involved in previous fundraising	178	1	5	2.25	1.108
Employing relative of an existing client	178	1	5	2.34	1.217
Valid N (listwise)	178				
Panel B: Quality of financial reporting					
First time recognition of environmental liability debited to accumulate profit	178	1	4	2.29	.964
Provision for warranty costs not recognized	178	1	5	2.11	.889
Impairment loss on asset, not recognized	178	1	4	1.88	.835
Restructuring provision incorrectly recognized as a liability at acquisition date	178	1	4	1.99	.880
Revenue recognized before installation completed	178	1	5	1.96	1.070
Employee share trust not consolidated	178	1	5	2.00	.968
Valid N (listwise)	178				
Panel C: Auditors' attitude towards CA					
Overstatement of post-retirement benefit liability to reduce earnings	178	1	5	2.12	.918
Sale and leaseback structured as an operating sale and leaseback risks and rewards of ownership remain with the seller	178	1	5	2.30	.966
Recognition of profit on forward exchange agreement	178	1	5	2.45	1.145
Revised likelihood of recovering an assessed loss from unlikely to probable when underlying circumstances had not changed	178	1	5	2.29	.923
Special Purpose Entity (SPE) not consolidated	178	1	5	2.07	.877
Controlled subsidiary not consolidated	178	1	5	2.05	.976
Revenue recognized when goods dispatched to an agent	178	1	5	2.25	1.219
Timing of delivery of goods delayed to next financial period	178	1	5	2.21	1.040
Valid N (listwise)	178				

Table 3: Spearmans' Rho Correlations

Panel B			EJ	QOFR	Attitudes
Spearmans' rho	EJ	Correlation Coefficient	1.000	.400**	.559**
		Sig. (2-tailed)		.000	.000
		N	178	178	178
	QOFR	Correlation Coefficient	.400**	1.000	.594**
		Sig. (2-tailed)	.000		.000
		N	178	178	178
	Attitudes	Correlation Coefficient	.559**	.594**	1.000
		Sig. (2-tailed)	.000	.000	
		N	178	178	178

**. Correlation is significant at the 0.01 level (2-tailed).