THE IMPACT OF CONDITIONAL CONSERVATISM ON CREATIVE ACCOUNTING: A SUGGESTED FRAMEWORK

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Abstract

This paper provides a framework of how conditional conservatism contributes to the reduction of creative accounting which in turn affects auditor fees, litigation risk, auditor independence and improved auditing quality. All these factors are reflected in the degree of stakeholders' confidence in financial reports. The absence of conservatism in the Financial Accounting Standards Board's (FASB) conceptual framework is due to its belief that conditional conservatism causes a bias in accounting information and that it compromises neutrality. However, by supporting conservatism with a set of controls including upgraded training, intensified effort of auditors, increased professional skills and activated audit committees, users' financial statement become more reliable which helps users make the right decisions.

Keywords: Conditional Conservatism, Creative Accounting, Auditor Fees, Litigation Risk, Auditor Independence

1. INTRODUCTION

Giving an accountant a high degree of flexibility in using appropriate accounting principles to preparing financial statements, the exploitation of many inappropriate alternatives and indirect accounting methods to achieve the interests of specific parties would provide misleading financial statements and reports (creative accounting). Gupta (2015) suggested that the subject of creative accounting is usually portrayed in maligned and negative ways. When the phrase 'creative accounting' comes to mind, the images usually associated with it are of manipulation, dishonesty and deception. However, this depiction is not entirely accurate. Creative accounting is a tool, which likes any other weapon, if used correctly, it can give great benefit to users, but if it is mishandled or gets into the hands of the wrong person, it can cause much harm. In actuality, creative accounting has helped more companies get out of a crisis than land them into crisis. The weapon is almost innocent; the fault lies with the user. The problem with the weapon of creative accounting is that when it is met with a negative attitude of the management board, it can cause the collapse of many companies.

Additionally, granting high fees to the auditor compared with his efforts in order to contribute to the negative side of creative accounting and to conceal fraud and misinformation in the financial report along with increased litigation risk, and threatening the auditor independence generally have serious implications for audit quality. Hoitash et al. (2007) found that there is a negative relationship between auditing fees and auditing quality. These practices have led to the collapse of many large companies around the world including Enron, WorldCom, Lehman Brothers Bank, and consequently the closure of one of the largest audit offices, Arthur Andersen.

On the other hand, accounting conservatism is seen as one of the most important argumentative issues currently in the accounting literature. Numerous previous studies found persuasive evidence that accounting conservatism is one of the most important accounting principles. This idea has increased over time (Sivakumar & Waymire, 2003; Kang et al., 2017). Accounting conservatism plays a major role in preserving the rights of shareholders, creditors, and other stakeholders. Similarly, conservatism is another one of the most important accounting concepts that has played an important role in accounting practices and is of great interest to accountants and auditors (Watts, 2003). However, it has faced many criticisms, especially after the concept of fair value appeared, from Financial Accounting Standards Board (FASB) and some researchers who believe that the use of the accounting conservatism is inconsistent with certain qualitative characteristics of accounting information such as relevance, neutrality, verifiability, and faithful representation. Accounting conservatism is vastly accepted to be a desirable qualitative characteristic of accounting information (Ball & Brown, 1968; Ruch & Taylor, 2015).

In contrast, some researchers believe that accounting conservatism arises neutrally between contracting parties and is necessary as an effective contractual mechanism (Basu, 1997; Watts, 2003). The use of accounting conservatism helps to achieve many economic benefits, contributes to the reduction of share capital, maintains a low level of litigation risk, and increases the auditing quality. Prior literature suggests that shareholders have a greater preference for conservative accounting practices as they reduce litigation risks and mitigate agency problems (LaFond & Watts, 2008; Ball et al., 2012). Furthermore, conservative reports are found to influence managers' decisions in issuing earnings forecasts (Hui et al., 2009). In addition, conditional conservatism serves as a measure of quality for mandatory financial reports. It also plays a complementary role in voluntary management forecast disclosures (Hui et al., 2009).

This study, therefore, provides a framework for using conditional conservatism to help rationalize stakeholders' decisions in financial markets. It is possible to obtain trustworthy and credible auditing reports prepared according to conditional conservatism policies with auditor independence that also positively affect the users of financial statements decisions. This will decrease auditor fees immensely and improve the quality of auditing reports which in turn will help increase stakeholder's confidence. Furthermore, the auditing reports are controlled by a group of factors which make it more credible.

The remainder of this research is structured as follows: an overview and background of creative accounting is presented in Section 2, including its definition, creative accounting techniques, quality of accounting information and specific properties of this information, and implications of the creative accounting practice. Section 3 discusses accounting conservatism, including its definitions, forms, and the role of conditional conservatism in a business environment. Section 4 presents and discusses the suggested framework, which clarifies the role of conditional conservatism in minimizing creative accounting, auditor fees, and other effects. Section 5 concludes this paper.

2. CREATIVE ACCOUNTING

Rapid changes in the global economy throughout the last decade of the twentieth century have caused many radical fluctuations in accounting fundamentals. In the light of company activity expansion and global marketplace expansion, some companies experienced financial scandals due to a desire to increase profit. Regardless of the success that some companies can achieve, the practice of immoral behavior through fraud and manipulation will reduce the helpfulness of annual reports (Hillier & McCrae, 1998); this will create thoughtful long-term complications (Clikerman, 2003). These scandals and the resulting collapse and bankruptcy caused users of financial reports to place attention and focus on the entities responsible for the preparation of financial reporting, namely accountants and auditors.

Gaps in accounting practices were the main reason that accountants attempted to improve the appearance of financial reporting in creative ways (creative accounting) which contributed to manipulating the data mentioned in the financial reports, which in turn, led to the emergence of financial scandals. The global economic crisis created an environment where accountants and auditors used creative accounting. Creative accounting is adopting unreliable procedures in order to hide financial or non-financial information. The financial information presented by auditors and accountants in companies' financial reports were not credible or of high quality (Cernusca et al., 2016). One of the most famous global financial scandals is the manipulation of Enron's financial reports by Arthur Andersen's audit company. Healy & Palepu (2003) argue that Arthur Andersen's audit company has been defendant of smearing lax standards in their reviews due to a struggle of interest and a desire to accomplish definite objectives. Because of this case, there has recently been a heightened interest in creative accounting.

Based on Vladu and Cuzdriorean (2013). Accounting information plays a main objective in the decision-making procedure, therefore safeguarding the justice and honesty in the financial data should be a significant issue. Given the importance of financial reports to their beneficiaries and the role of these reports in decision making, it has become necessary to pay more consideration to the integrity and ethics of creative accounting of submitted financial reports and to exclude any accounting practices that would lead to manipulation and fraud of the information provided in those financial reports. We cannot ignore the importance of morals in the creative accounting of financial annual reporting and this is the approach a reasonable attitude must be reserved in mind while doing financial reporting (Amat & Gowthorpe, 2004). Creative accounting has been documented extensively in previous research and most researchers believe that creative accounting data must be treated with caution because it involves unethical conduct (Abernethy et al., 2012).

2.1. Definition of creative accounting

Creative accounting is the method of manipulating accounting practices to hide the actual performance of companies in order to achieve results that benefit the company or some of its employees. Such methods are described as "creative accounting" if they take advantage of certain gaps or use flexibility in applying accepted standards and principles, but do not exceed the standards and principles. Practicing creative accounting reduces confidence in the information contained in the published financial statements. Creative accounting allows companies' flexibility in the preparation of financial statements and it allows companies to benefit from the gaps in the standards. Although creative accounting should not be illegal, managers need to find solutions that uphold the integrity of their work in spite of financial pressure (Berisha & Shala, 2014).

There are several definitions of creative accounting. Creative Accounting refers to the use of accounting methods to affect the financial statements while remaining within accounting rules (Gupta, 2015). The financial statements will display the company's performance in a more positive light; thus, the management will want to share the report with the stakeholders. The transformation of financial accounting figures from what they actually are to what the preparer desires them to be by taking advantage of the existing rules and/or ignoring some or all of them, this is the creative accounting as Naser (1993) defined. Karim et al. (2017) described creative accounting as aggressive accounting because the manipulation of financial numbers within the parameter of accounting standards does not provide the true and fair view of companies. Creative accounting is any action taken by management that affects reported income, but that does not provide any real economic advantage to the company and that will be detrimental to them in the long-term (Merchant & Rockness, 1994). Jones (2011) distinguished between creative accounting and fraud as the first term operates within a regulatory framework, while the other term involves legal violations and breaches of the regulatory framework.

So, we can define creative accounting as one of the methods of manipulation of accounting practices using the elements of flexibility and the difference is not supported to work to exceed the principles and accounting standards in order to manage profits or hide the actual performance of firms.

2.2. Creative accounting techniques

Creative accounting is practiced by exploiting loopholes. It is concentrated in the following six areas: regulatory flexibility, a dearth of regulation, a scope for managerial judgment in respect to assumptions about the future, the timing of some transactions, the use of artificial transactions and finally the reclassification and presentation of financial numbers (Largay, 2002; Mulford & Comiskey, 2002; Amat & Gowthorpe, 2004; Gupta, 2015). For regulatory flexibility, accounting regulations often permit a choice of policy. For example, the International Accounting Standards permit a choice between carrying non-current assets at either revalued amounts or at depreciated historical cost; also in respect to accounting for stock options, there are a few mandatory requirements because some areas are simply not fully regulated (dearth of regulation) (Amat & Gowthorpe, 2004; Gupta, 2015). Management has considerable scope for estimation especially in discretionary areas such as debts provision. The managers of the business are free to choose in which year they sell the investment which will increase the profit in the accounts when they have an investment at a historic cost which can easily be sold for a higher sales price than the current value. This is known as timing manipulation (Amat & Gowthorpe, 2004; Gupta, 2015).

2.3. Quality of accounting information and specific properties

There is a group of properties associated with the excellence of accounting information that greatly contributes to making this information more useful and beneficial, which in turn contributes positively to decision-making. We will briefly review the concept of accounting information quality and the most important properties affecting this information.

2.3.1. Quality of accounting information

Information and data help management in guiding daily business, assessing past performance and planning for the future. As it is known, accounting is the means of reporting or communicating such information or data to beneficiaries. This information must be reliable and of high quality to benefit beneficiaries in achieving their desired objectives. Accounting information quality is the extent to which the accounting information provided reflects the current status or financial performance of companies and contributes to predicting future financial performance (Dechow & Schrand, 2004).

Quality of information is the primary criterion that measures the extent to which accounting information achieves the objectives required. In order for this information to be of quality, it must be beneficial, which means the accounting information is useful to users when making their decisions. Therefore, the meaning of quality is effectiveness. Gelinas et al. (2011) used the term effectiveness of the information system as a measure of the success of the information in achieving the desired objective. Nicolaou (2000) said that the effectiveness of information systems is a requirement for the information user. The most important factors that measure the effectiveness of the information system is the user's satisfaction, individual effect and organizational effect (DeLone & McLean, 2003).

A variety of reviews of IFRS-concerned research have been investigating the impact of accounting standards on the quality of accounting information. Hail et al. (2010) review IFRS researches to identify the implications of US corporations converting into IFRS. They investigate the impacts of IFRS adoption on reporting quality and capital market. Pope and McLeay (2011) review the IFRS papers and discuss the implementation of IFRS across EU. Ahmed et al (2013a) conduct a meta-analysis of IFRS literature and investigate the impacts of IFRS application on value relevance, analyst forecasts and discretionary accruals. Emmanuel et al. (2016) review the literature on the consequences of IFRS adoption. They find that majority of studies paint IFRS as bringing important benefits to adopting corporations and countries in terms of (1) enhancing transparency through enhancing financial reporting quality, (2) lower costs of capital, (3) developed cross-country investments, and (4) increasing foreign analysts.

Several previous works investigate the consequences of accounting information quality (e.g., Onali & Ginesti, 2014; Barth et al., 2014 and Chen & Khurana, 2015). For example, Onali and Ginesti (2014) test the market reaction to IFRS for European listed companies. They find a positive reaction to the introduction of IFRS. The result recommends stockholders perceive new regulation as shareholder-wealth support perspective that stronger comparability across accounting standards of European companies is beneficial to international. Barth et al. (2008) investigate whether the adoption of IAS is linked with accounting quality. They find corporations that using IAS from 21 countries has more value relevance of accounting amounts than do matched sample corporations using non-US local standards. Variations in accounting quality between the two groups of corporations in the period before IAS corporations adopt IAS do not account for the post-adoption variances. Corporations adopting IAS evidence an improvement in accounting quality between the pre- and post-adoption periods.

Bartov et al. (2005) compare value relevance across German corporations that reported under US GAAP, IAS or local German GAAP. They find higher value relevance for corporations that reporting under both IAS and US GAAP than under domestic GAAP. Barth et al. (2012) find value relevance of book value of equity and net income following IFRS adoption enhanced under IFRS. Barth et al. (2014) investigate whether reconciliations of domestic GAAP numbers to IFRS numbers are value relevant to stockholders depend on 15 European countries. They find reconciliation adjustments for net income and book value of equity are value relevant in the sense that they are cross-sectionally concerned with stock prices. The previous finding has been supported by Barth et al. (2001). Chen and Khurana (2015) document a positive stock market reaction for US cross-listed companies that report under IFRS relative to a benchmark sample of cross-listed non-IFRS and local US companies.

The quality of accounting information is determined based on specific properties that must be apparent within it. These properties help to assess the information and measure its efficiency and effectiveness.

2.3.2. Specific properties of this information

There are primary, secondary and subsystem properties that must be included in accounting information to make it useful. These properties are the criteria for measuring the efficiency and effectiveness of this information, determining the quality required to achieve the desired objectives, and activating its role in influencing beneficiary decisions.

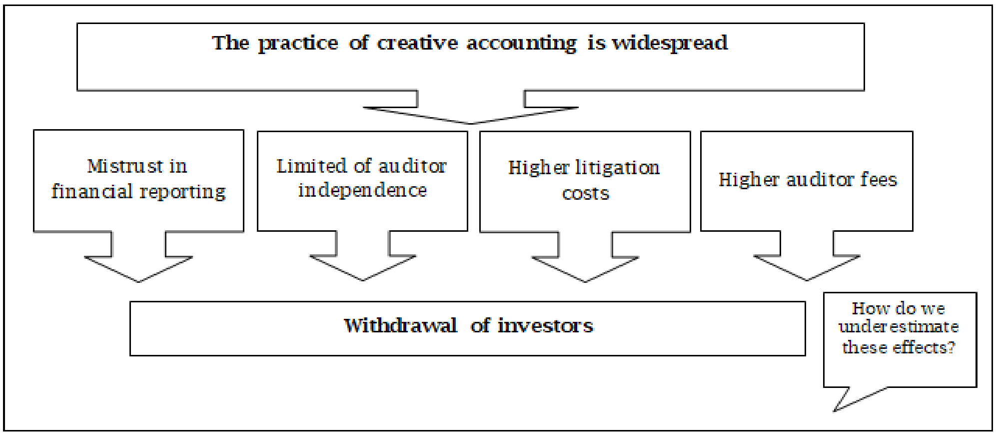
As Cernusca et al. (2016) said there are two categories of qualitative characteristics: fundamental characteristics (relevance and accurate representation), and secondary characteristics (comparability, verifiability, timeliness, intelligibility). Relevance is the first primary property; the information will be relevant when it meets the needs of the users. To achieve this, there must be three main factors available, which are timeliness, predictability and feedback value. The second primary property is reliability; the information provided must be reliable in decision-making. This can be achieved through three main factors, which are objectivity, the possibility of verifying information, and the proper presentation of this information. There are secondary properties such as comparability, by applying the principle of consistency in the use of policies to enable the fair comparison of accounting data. In addition, the Financial Accounting Standards Board's (FASB) has identified two basic subsystem properties which are cost and benefit and materiality.

2.4. Implications of the creative accounting practice

There are several accounting methods that management can choose from to provide information to beneficiaries in order to help them make informed decisions. The accounting method that management chooses to use depends on their own objectives, keeping in account that the chosen method does not have any negative impact on the transparency of the declared information; transparency means that the information should be relevant, timely, and reliable (Williams, 2005). The existence of this diversity in accounting methods and the gaps in some of these methods can result in misleading data. The multiplicity of these methods enhances the usefulness of the accounting information for the company and its objective (Tabara & Rusu, 2011). The administration seeks to influence the decisions of the beneficiaries, investors and commensurate with their objectives. One of the most important aims is to inflate profits. Karim et al. (2014) agree that the amplification of profit figures is the typical aim of creative accounting. Creative accounting helps to reduce the fluctuations of companies' income and reflects a good image in the market (Nag, 2015). So, the practice of creative accounting does not give a realistic image of the company's situation and does not reflect the current economy. This is the reality of the economic growth of the 80s, where this growth was due to creative accounting which depends on the skills of accountants rather than real economic growth (Smith, 1992).

Figure 1 describes the implication of the widespread practice of creative accounting and the limited use of accounting conservatism. As is shown, the most prominent of these effects are higher auditor fees, higher litigation costs, limited of auditor independence, and mistrust in financial reporting. All of these factors contribute significantly in the long term, resulting in the withdrawal of investors.

Figure 1. Implications of the creative accounting practice



Many researchers have studied creative accounting and demonstrated the negative impact it has had on financial information. The most prominent of these effects are higher auditor fees. The practice of creative accounting and narrowing the scope of accounting conservatism increases the auditors' efforts as they are required to achieve company goals by taking advantage of the gaps in the system. This extra effort increases the fees of the auditor and increases the costs for companies (Lee et al., 2015). Also, higher litigation costs, users have the right to resort to judiciary means in order to sue the external auditors who have put forth incorrect financial statements. Therefore, attention should be paid to the breadth of liability as the auditor is legally responsible to these users. When information is misleading and serves the company's own objectives (creative accounting), which will increase the number of lawsuits and claims. This misleading information will also negatively affect the auditor's independence and will cause the loss in confidence of their clients. Moreover, limited auditor independence and mistrust in financial reporting. An external auditor's examinations of financial statements and reports increase the confidence in the quality of the data provided and the profits recorded. Thus accounting information is respected more by users if the auditors are independent and neutral in regards to the information presented in the reports.

All these factors contribute significantly to the withdrawal of investors. The breadth of creative accounting being practiced is the result of the narrowing of the scope of the accounting conservatism.

3. ACCOUNTING CONSERVATISM

Lately, accounting conservatism is one of the most important aspects of financial reporting and is considered to be a key qualitative characteristic of the reports (Bangmek et al., 2016), Accounting standards usually include conservatism principles, such as lowering of cost or market accounting for inventory and impairment accounting for tangible and intangible assets (Ball et al., 2000a; Wyatt et al., 2001; Kabir & Laswad, 2014). Over the last two decades, research on conservatism has flourished and the findings show that financial reporting is conservative in many markets (Basu 1997; Ball et al., 2000a, 2000b, 2003). Nevertheless, in 2012, conservatism (prudence) was excluded from the joint conceptual framework proposed by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), even though it plays an important role in financial reporting (Zhong & Li, 2017).

Accounting systems are used to reflect firms' economic circumstances and one essential issue of accounting concerns the means by which economic values are mapped to earnings. A firm's economic value can be broken down into a realized and unrealized part. The realized part is objective and is recognized in earnings through cash flows, whereas the unrealized part must be predicted and subjective. The accounting process occurs on an accrual basis, which plays a central role in financial reporting. How the unrealized part is recognized in earnings determines the properties of financial reporting, such as its relevance and reliability. Accounting conservatism is an important principle in the accounting process. The unrealized part of economic value can be further divided into 'good news' and 'bad news', where 'good news' indicates positive expected cash flows and 'bad news' indicates negative expected cash flows (Zhong & Li, 2017). Much interest has been placed on the topic of "conservatism" or "prudence" in accounting literature following the removal of the terms from the Conceptual Framework for the Financial Statement of 2010 and its subsequent reinstatement into the Exposure Draft Conceptual Framework of 2015. The Exposure Draft Conceptual Framework 2015 states that conservatism or prudence is important for achieving neutrality. It is an aspect that makes financial statements useful to investors (IASB, 2015). Conservatism and financial statement verifiability are important characteristics of the generally accepted accounting principles (GAAP) (Kothari et al., 2010; Francis et al., 2013).

Accounting Conservatism embraces the application of a higher verifiability standard which recognizes good news as gains rather than bad news as losses (Watts, 2003; LaFond & Watts, 2008; Ball et al., 2008; IASB, 2015).

Basu (1997) interprets accounting conservatism as capturing accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements. Therefore, 'good news' is recognized gradually over time, while 'bad news' is incorporated into earnings in a timely manner in the current period. Both 'good news' and 'bad news' are usually recognized through accruals (Zhong & Li, 2017).

3.1. Accounting conservatism definitions

In light of the recent increase in interest surrounding accounting conservatism, many definitions of the term have appeared. Both scholars and accounting standard setters have attempted to provide a generally accepted definition of accounting conservatism. Statement of Financial Accounting Concepts (SFAC) No.2 defines conservatism as follows: "Conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered. Thus, if two estimates of amounts to be received or paid in the future are about equally likely, conservatism dictates using the less optimistic estimate" (FASB, 1980). Furthermore, Watts & Zimmerman (1986) refer to conservatism as reporting the lowest value among possible alternative values for assets and the highest alternative value for liabilities. This definition accounts for financial reporting and suggests that conservatism is a feature of financial reporting; also a focus on revenue should be recognized later than sooner, and expenses, sooner than later (Zhong & Li, 2017). On the same context, Accounting conservatism can be defined as accounting policies or tendencies that result in the downward bias of accounting net asset value relative to economic net asset value (Rush & Taylor, 2015).

Several researchers identify various benefits associated with conservative financial reporting. Zhang (2008) finds that conditional conservatism increases the efficiency of debt contracting and reduces the cost of debt. Garcia Lara et al. (2011) find that conditional conservatism reduces information asymmetry and the cost of equity.

3.2. Accounting conservatism forms

Conservatism can be categorized into conditional conservatism or unconditional conservatism (Mora & Walker, 2015). The primary difference between the two forms of conservatism is that the application of conditional conservatism depends on events in economic news, while the application of unconditional conservatism does not (Rush & Taylor, 2015).

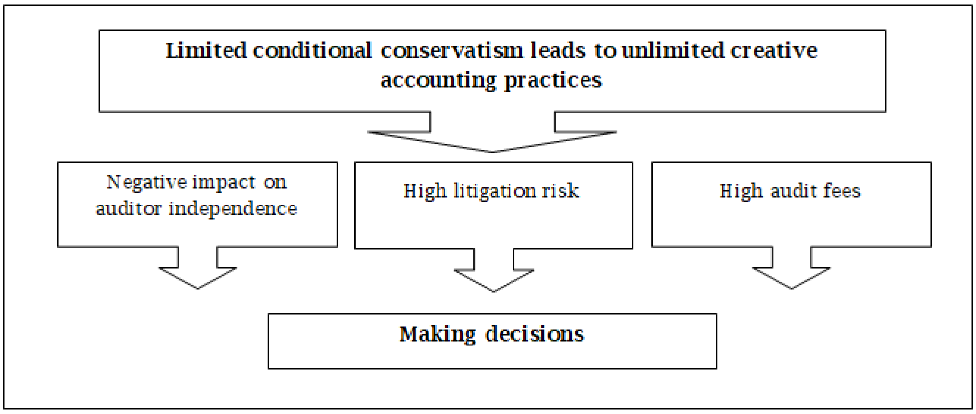
There are many definitions of unconditional conservatism. Bandyopadhyay et al. (2010) refer to unconditional conservatism as accounting practices that reduce earnings and net assets in an unavoidable manner. Unconditional conservatism is also called news-independent or ex-ante conservatism which means that aspects of the accounting process determined at the inception of assets and liabilities yield the expected unrecorded goodwill (Ji, 2013). In contrast, Rush & Taylor (2015) defined unconditional conservatism differently. Their definition does not depend on economic news. Instead, they define it according to the cause. Conservatism is caused and occurs through the consistent under-recognition of accounting net assets. Examples of unconditional conservatism include immediately expensing research and development expenditures, accelerated depreciation, and the amortization of long-lived assets at a rate above the expected economic amortization rate (Ji, 2013; Rush & Taylor, 2015).

On the other side, conditional conservatism, also called news-dependent or ex-post conservatism, means that book values are recorded under sufficiently adverse circumstances, not favorable circumstances (Ji, 2013). In the same context, Rush & Taylor (2015) explain that conditional conservatism occurs when negative economic news is recognized in accounting earnings in a timelier manner than positive economic news. In other words, it is characterized by the asymmetric recognition of positive and negative economic news. Examples of conditional conservatism include the asymmetric treatment of loss and gain contingencies, accounting for inventory using the lower-of-cost-or-market convention and impairment accounting for long-lived tangible and intangible assets (Ji, 2013; Rush & Taylor, 2015).

3.3. Limited conditional conservatism

Without a doubt, the limited scope of conditional conservatism allows for creative accounting practices to become prevalent. Hence, the choice between accounting methods is broadly based on achieving management objectives or stakeholders' objectives, resulting in many problems as presented by the Figure 2.

Figure 2. The consequences of the limited conditional conservatism



It is clear from the preceding figure that the implications of the limited range of conditional conservatism coupled with an unlimited scope of creative accounting are the following:

- Higher fees are required by the auditors because they exert a lot of effort to discover and use creative accounting practices that negatively effects on financial reporting credibility, and the limited scope of the accounting conservatism raises the fees of the auditors as indicated by the study of Lee et al. (2015).
- The risk of litigation by stakeholders is increased because auditors are unable to detect fraud in statements and financial reports as indicated by the study of Liu & Elayan (2015).
- The negative impact on auditor independence is due to the increased risk of litigation from stakeholders against auditors for not detecting all creative accounting practices.
- All previous effects lead to switching the auditing firms from Big N to smaller non-Big N firms because of decreasing conditional conservatism in firms under auditing, especially when they have relatively weaker corporate governance (Mitra et al., 2016), and therefore decreasing the confidence in the audit reports, so investors will take irrational decisions.

Based on the above, the benefits that can be achieved through the conditional conservatism are presented in the following points.

3.4. The Role of conditional conservatism in business environment

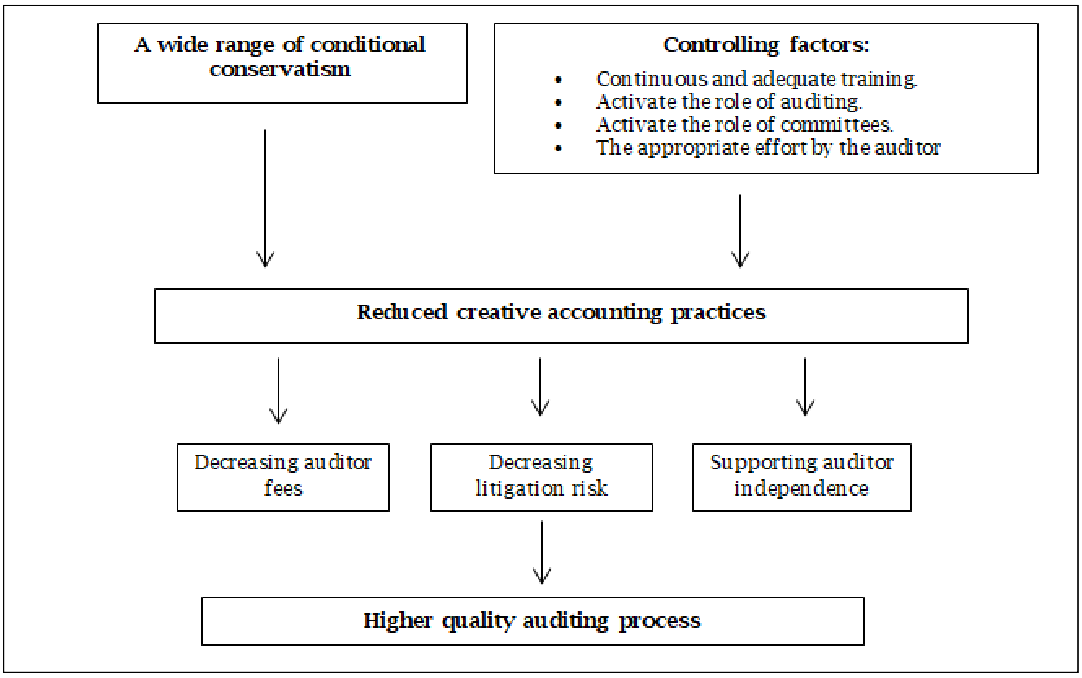
- Conditional conservatism ensures that reported earnings incorporate expected losses in a timely manner while expected gains are only reported when they are verified. The disclosure of economic losses in a timely manner helps to reduce agency costs or alleviates, and this cost which has been incurred through information asymmetry between managers and investors (Watts, 2003; Ball & Shivakumar, 2005; LaFond & Watts, 2008).
- Conditional conservatism reflects the quality of financial reports and provides an early warning of a decline in performance (Ball, 2001; Ball et al., 2008; Kothari et al., 2010; Mora & Walker, 2015). This entire will economic event can potentially increase the value relevance of earnings number (Bandyopadhyay et al., 2010; Kim & Kross, 2005).
- Conditional conservatism serves as a measure of quality for mandatory financial reports. It also plays a complementary role in voluntary management forecast disclosures (Hui et al., 2009).
- Conditional conservatism provides investors with verified accounting information for monitoring corporate investment decisions and for assessing the firm's future cash flows (Bangmek et al., 2016).
- Conditional conservative reports help to establish a better benchmark that depicts the firm's current and future financial performances while providing a more verifiable and lower bound measure of earnings and net asset values (Watts & Zuo, 2012; Kim et al., 2013).
- Auditors demand conservatism because they suffer from information asymmetry and asymmetric payoffs. Auditors are responsible for the reliability and verifiability of financial reporting. When firms are subject to financial fraud, auditors face reputational harm and risk of prosecution by shareholders (Zhong & Li, 2017). In the same context, Palmrose & Scholz (2000) find that auditors are more likely to be sued when financial statements are restated. For example, Arthur Andersen faced litigation and became bankrupt after the Enron scandal. Time-series variations in conservatism are consistent with this explanation.
- Higher ex-ante litigation risk induces greater conditional conservatism at a later time when managers and auditors take asset write-downs or recognize other losses as a defensive strategy to reduce ex-ante litigation risk (Liu & Elayan, 2015).

Finally, as it clears in the previous sections, there was a great similarity in the negative effects of creative accounting practices and the limited scope of conditional conservatism. Therefore, in the following section, the suggested framework will focus on how to fix the causes to avoid the negative effects resulted, which will lead to investor confidence in financial reports more and more and take rational decisions.

4. ROLE OF CONDITIONAL CONSERVATISM IN MINIMIZING CREATIVE ACCOUNTING, AUDIT FEES, AND OTHER EFFECTS

It is possible to obtain trustworthy and credible auditing reports prepared according to conditional conservatism policies with auditor independence that also positively affect the users of financial statements decisions. The quality of auditing is determined by conditional conservatism, auditor independence and auditor services. Therefore, an independent auditor using conditional conservatism will try to detect fraud and deception that could occur with creative accounting. This will reduce the risk of litigation was faced by the auditor. In addition, enhancing conditional conservatism will help stakeholders to take and rationalize decisions in uncertain business environments. Another greater advantage is reaching a state of mutual confidence between all parties in the business environment. Undoubtedly, this will decrease auditor fees immensely and improve the quality of auditing reports which in turn will help increase stakeholder's confidence. Furthermore, the auditing reports are controlled by a group of factors which make it more credible. This is shown in the figure below.

Figure 3. The suggested framework of conditional conservatism and creative accounting



4.1. Conditional conservatism versus creative accounting

By applying the highest level of corroboration with determining the revenues against determining the losses, conditional conservatism may reduce stakeholders' risks by ensuring correct information and by lowering the uncertainty that results from creative accounting. When any negative economic events occur, the value of both profits and net assets is reduced when using conditional conservatism. However, Basu (2005) and Ryan (2006) show that an increase in previous values don't essentially happen when there are positive economic actions. Consequently; the degree of flexibility available to the accountant would be limited and that will reduce corporate breakdowns.

4.2. Conditional conservatism versus auditor fees

It is clear that auditor fees reflect the effort made by him. As creative accounting practices become more prevalent, auditor's efforts will increase significantly. Thus, the cost of the audit will increase and that may be unacceptable for certain stakeholders. Zhong & Li (2017) find a positive association between auditor fees and creative accounting. The increase in auditor's fees may be due to two things: the first may be collusion with the firm to manipulate the financial reports; the second may be doing the best effort to discover the most productive creative accounting practices. On another hand, if creative accounting practices decrease, the effort needed by auditors will also decrease and fees will be reduced.

In addition to the above, widely-used conditional conservatism along with a quality of corporate governance will minimize audit fees. In other words, firms with limited conditional conservatism and low corporate governance quality will face a risk of collapse and litigation. Furthermore, the presence of supported factors helps the auditor to concentrate his efforts in areas of high risk, giving him an acceptable degree of certainty in detecting errors. Therefore, the accuracy of the financial statements will be improved which will positively impact the confidence of the clients resulting in capital markets working efficiently. The factors that support the auditor allowing for a decrease in his fees while also keeping his independence are determined in conditional conservatism. This is illustrated in the previous figure.

4.3. Conditional conservatism versus litigation risk

One of the negative effects of creative accounting practices was the bankruptcy of a varied group of US firms because of collusion with auditors, negligence by auditors, manipulation of financial statements and the relinquishment of independence. All these reasons led to a sharp drop in corporate stock prices in the capital markets, resulting in substantial losses to shareholders and increased litigation risk against auditors (Liu & Elayan, 2015). Ultimately, it led to the closure of big audit firms as they were partly responsible for the collapse of these firms. We can minimize these negative effects in the short-term and reduce them in the long-term by restricted conservatism. Conditional conservatism decreases lawsuit risk, as the disproportionate appreciation of economic profits is closely linked to judicial claims against auditors. Excessive valuation of net assets or overvalued profits causes auditors to raise their fees in order to protect themselves. The practice of more conservative accounting policies such as the minimization of profits by transferring them for future periods can lead to a decrease in litigation risks. As shown in the previous figure.

4.4. Conditional conservatism and support auditor independence

Users of financial statements base their confidence on reports by the level of independence and neutrality of the external auditor. The independence of an auditor is achieved by having full awareness of the ethics and conduct of the audit profession and by recognizing the value of conditional conservatism. If this is achieved, independent auditors can reap the benefits of auditor independence and increase the confidence in financial statements (Palmrose & Scholz, 2000), as illustrated in the previous figure.

4.5. Conditional conservatism and support auditing quality

Undoubtedly, widespread using of conditional conservatism while limiting the scope of creative accounting in a business environment will lead to greater reliability in financial statements. Thus will achieving many positive effects, such as lower audit fees, reduced litigation risk, and more keeping auditor independence. Ultimately, it will facilitate the auditor's role in detecting fraud and weaknesses, or gaps in financial statements that will finally improve the auditing quality, as illustrated in the previous figure.

4.6. Controlling factors in the suggested framework

There is a range of controlling factors that researchers expect to have a clear impact on the suggested framework and which should be taken into account, as follows:

- Continuous and adequate training to increase the performance of auditors in order to keep up with the auditing profession.
- Activate the role of auditing committees, as one of the important mechanisms to ensure the efficiency of external and internal review services in additional to preserve the independence of auditors, and reduce the practice of creative accounting, thus maintaining the level of auditor fees on the reasonable level.
- The appropriate effort by the auditor when providing his services.

Finally, we would like to point out that the researchers do not want to abolish creative accounting; rather we suggest limiting the scope of creative accounting and increasing the range of conditional conservatism. This will result in improving the financial position of firms and reducing the cases of corporate collapses and bankruptcy.

5. CONCLUSION

This paper has studied the impacts of restricted conservatism on creative accounting, and auditor fees with indirect manner. As we know creative accounting is the financial reporting tricks adapted to moderate corporation's financial reports to inspire stockholders to purchase the business' shares to raise the organization's market value. There is no doubt that creative accounting has sharp negative effects as increasing auditor fees and litigation risk, and effect on auditor independence in order to conceal fraud and misinformation in the financial report, all of these things have serious implications for audit quality in general.

On the other side, conditional conservatism may reduce stakeholder risks by lowering Misinformation and the uncertainty that results from creative accounting, through application of the highest degree of confirmation when appreciation of profit in contradiction of the recognition of losses. Based on the conditional conservatism, the amount of net assets value, as well as the profits, is reduced once if any negative economic events occur. However, Basu (2005) and Ryan (2006) argue that increases in previous values don't necessarily happen when there are positive economic proceedings. So the degree of flexibility available to an accountant would be limited, and that will follow with reducing corporate breakdowns.

Through our suggested framework achieving wide range-conditional conservatism and limited scope of creative accounting in business environment, will lead to greater reliability in financial statements, and accordingly facilitate auditor role in detect fraud and weaknesses and gaps in financial statements and which is sustained over access to adequate and substantial indication, then skimpy it to the interested parties of these statements. Through conditional conservatism, and so on reducing litigation risk, as the asymmetric recognition of economic profits is closely linked to judicial claims against auditors. With decreasing creative accounting cases, will be followed by a reasonable effort by the auditor, and then reduced his fees and keeping auditor independence. Finally, the stakeholders can make good decisions.

The suggested model in this study is important for many interested parties as policymakers as well as investors. Understanding the consequences of conservatism may help the board in the corporations to consider all techniques to reduce the level of creative accounting. Thorough reducing level of earning management, the trust level for the investor will increase and the value of the firm will develop. Understanding the different association as well as the impact of creative accounting and conservatism may motivate policymakers as regulators and central banks to update and develop accounting standards as IFRS, GAAP and AAOIFI to mitigate the level of unethical behavior as creative accounting which will affect positively on the value relevance and quality of accounting information. Moreover, our suggested framework has a significant implication for all interested parties about the quality of annual reports through developing and increasing its credibility by reducing the level of manipulation practices in earnings.

Finally, we acknowledge the below limitation which we hope will serve as a prompt for future studies. However, our investigation is constrained to the exploration field of conservatism and creative accounting from the theatrical perceptive. Future research may measure the practical association between conservatism and earnings management. Future research also may test our suggested framework on the actual sample in MENA and GCC region. Furthermore, our model just investigates the impact of conservatism on auditing fees; support auditor independence; litigation risk and auditing quality, while future research may add additional factors for this model such as corporate governance in addition to country features such as culture and inflation. Finally, future research may adopt qualitative method as interview and questioner to test our model see for what extent conservatism can effect on the creative accounting and on auditing process and its quality.

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