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## The influence of cosmetic accounting on the stock exchange

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### Abstract:

This study aims to study Cosmetic Accounting and determine the extent of its use by Saudi public shareholding companies listed in the Saudi exchange stock market. It will also shed light on the effect of Cosmetic Accounting on targeted companies' share prices between 2010 and 2014. This study proceeded with a sample of 50 Saudi public shareholding companies covering all sectors of listed companies in the Saudi stock exchange market except banking, financial services & insurance sectors. This study concludes that 45% of the Saudi companies under test used Cosmetic Accounting during the studied period. The study also finds that Cosmetic Accounting affects share prices in the Saudi stock market (direct proportion).

**Keywords:** Cosmetic Accounting, stock market, Saudi.

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## 1. Introduction :

Creative accounting is also referred to as earnings management, income smoothing, cosmetic accounting, and financial engineering. All these terms apply to the exploitation of the flexibility found in some accounting rules to show the figures in the financial reports according to the needs of the company's management (Karim,Fowzia&Rashid,2011).

Accounting aims to identify, measure, and communicate financial information that can evaluate the company's economic performance and guide users in making decisions and forecasting the company's future cash flows.

The financial statements are considered the final product of the financial accounting information system. They are the primary means for communicating the accounting information on the economic events that occurred to the establishment during a period to the various parties. The validity of these decisions depends mainly on the accuracy and integrity of the information contained in these statements, i.e., match Declared information with the actual performance of the facility. (Marza et al., 2017).

Financial statements are an essential means to provide information regarding the performance and status of the company to various stakeholders of the company like investors, employees, financial institutions and regulators, etc. So it desired to fulfill the principles, regulations, and standards in preparing the financial statements to give an accurate and fair view regarding the company so that the stakeholders can take appropriate decisions after proper evaluation of the company's financial statements. Cosmetic Accounting distorts reality, which may mislead users of financial statement information. ( Vâlcu. et al. 2019)

It is expected that the companies' departments will prepare these financial statements within the framework of generally accepted accounting rules and principles. As well as following international accounting standards, or accounting standards for each country, these departments enjoy broad flexibility in choosing between policies, procedures, and alternative accounting methods in what is termed "Cosmetic Accounting" (Al-Quray, 2013).

In the last two decades, Cosmetic Accounting has become a topic for many specialists in the field, but its treatment is still insufficient. It is essential to understand where we make the delimitation between manipulation at the limit of legality and fraud both for the accounting experts and for other categories of users of accounting information. It is essential is critical to recognize a clear distinction between the two notions. In contrast, fraud and Cosmetic Accounting are merely the imprecision and incompleteness of accounting standards. They are not always moral behavior or motivated to portray reality accurately.

Unlike fraud and Cosmetic Accounting, understanding a smooth line between the two concepts exploits only the imprecision and incompleteness of accounting regulations, which is not always a moral practice or practice based on the intention to reflect reality faithfully. On the contrary, it has the intention to cheat, to mislead. There are many opinions for and against the use of creative practices. The flexibility of norms gives accounting options that privilege specific categories of users and under privilege other categories of users. Our purpose is to draw attention to these issues so that the accounting information users can analyze the figures presented by the financial statements as objectively as possible. We are not for or against these Cosmetic Accounting techniques, but we want to know their limits and the limits to which they stay legal. It is for everyone to consider up to which limit they are moral. (Gînta& Țirău,2018).

The practice of Cosmetic Accounting has resulted in damage, financial scandals, and collapses of major international companies. The most famous of scandals is the American energy company (Enron) in (2002). As well as the American communication giant (World Com) made massive distortions in the results of its published financial centers. He led Due to a significant drop in the market price of these companies' shares in the financial markets (Ahmed, 2010). Before the collapse of these companies, there were many cases of bankruptcy of banks, companies, and institutions. Accounting offices and their boards of directors had a direct role in manipulating numbers, preparing budgets, and collapsing some financial markets. Such as the collapse of the American market (1929, 1987, and 2000), the collapse of the Kuwaiti market (1982), and the markets Asiana (1987).

The collapse of the Saudi stock market was known as the February-March crisis in 2006 and the global financial crisis (2008). In what was known as the mortgage crisis, then the Saudi financial market crisis in 2014 had a significant impact on investors, leading to a loss of confidence in the results. In this case, companies listed in the Saudi Stock Exchange and their published financial center had collapsed the stock prices in the Saudi market.

In addition, the announcement of the results by Etihad Telecom Company (Mobily) for the fiscal year (2014) on 21 Jan 2015, achieving profits of (220) million Saudi riyals for the whole year. Then it soon announced a loss of (913) million Saudi riyals for the same year. After that, the external auditor issued a new amendment to the financial statements for the year (2014); on 30 July 2015, these lists showed that Mobily's losses increased to (1,576) million Saudi riyals. (Tadawul website, <http://www.tadawwul.com.sa>).

These events raised many questions about the lack of transparency and disclosure of information related to the financial positions of Saudi companies and the results of their business, which led to doubts about the safety of the numbers contained in their accounts and financial statements. In the stock market, the information shown in the financial statements is of great importance to investors, so the attempt to influence these lists

through the practice of Cosmetic Accounting or any of its various forms, the market will respond to in a way that is commensurate with it, positively or negatively.

Thus, the study aims to understand the subject of Cosmetic Accounting and to know the extent of its use by Saudi public shareholding companies listed on the Saudi Stock Exchange. It also sheds light on the impact of Cosmetic Accounting on target companies' share prices.

### 2. Literature review:

Defining the concept of "Cosmetic Accounting" may seem, at first sight, a straightforward thing. A current topic in the literature, an actual phenomenon that has been shaped mainly by largescale scandals such as Enron, Parmalat, or Andersen's consulting firm, does not have a single definition for all the aspects that compose it. Many authors have built definitions to explain this concept. It was described as a process in which the enterprise management takes advantage of the shortcomings or the blurs in the accounting rules to present a modified image of the results; (Shah, 2009).

Alternatively, as a transformation of the annual accounts, by using the accounting options, estimates, or other practices accepted by accounting regulations (Amat&Gowthorpe, 2004).

Lan Grifflis stated that Cosmetic Accounting refers to how companies manipulate profits by preparing accounts and preparing them to improve the value of their profits and raise the value of the enterprise in the money market. Furthermore, this manipulation is permissible. There is no objection to it because it takes place within the scope of accounting principles and rules that management enjoys relative freedom to choose from, so this is considered legitimate. It is the accounting of creativity. "(Lan Grifflis, 1986).

While (Michael Jameson) pointed out that "the treatment of accounting operations is carried out by many methods and methods that may lead to different estimates, which leads to an apparent conflict between the results of financial operations resulting from the use of those alternatives. Opportunities for manipulation, deception, and dishonesty of the results of financial operations These activities are practiced by a minority of accountants and are known as Cosmetic Accounting "(Jameson.1988.).

While (Terry Smith) believes that "the significant and clear growth in profits in 1980 AD is due to accounting deception and manipulation by the accountant's team, and not as a result of economic growth, and this is expressed in the existence of Cosmetic Accounting" (Smith.1992).

(Ukenna, &Ugwuanyi) indicated that "Cosmetic Accounting is about" converting financial accounting numbers from what they are to what the compilers desire by exploiting or taking advantage of existing laws or ignoring some or all of them. Okoye, Ukenna, &Ugwuanyi (2009).

Cosmetic Accounting is a shift and change in financial accounting numbers from their true form to the required form, to achieve advantages by choosing between alternatives to accounting rules or by ignoring some of them." (Brauweiler et al. 2019).

Ioana considered Cosmetic Accounting "the process of changing accounting numbers from the real form to the desired form, to achieve advantages for the company and its management upon disclosing this information. This last is done by choosing between alternatives to accounting policies or by ignoring some of them." (Ioana, 2019).

Cosmetic Accounting has also been defined as "some of the accounting procedures that the company's management sometimes resort to in pursuit of a fictitious (unreal) improvement either in its profitability or in its financial position, by exploiting the existing gaps in external auditing methods or taking advantage of the multiplicity of alternatives. Available in the accounting policies that allow the establishment's accounting standards to follow in the measurement and disclosure methods used in preparing the financial statements (Rossetto & Chapple, 2019).

Referring to the above, it can be said that Cosmetic Accounting is deliberate management practice when preparing and presenting the company's financial reports.

Also, they take advantage of the flexibility involved in accounting standards and principles in choosing between accounting methods and policies and the discretionary power granted to it to estimate some elements of financial reporting to affect the company's income in the short term. The financial reports give a different picture to reality to achieve predetermined goals such as financial analysts' expectations or the administration itself regarding future profits or maintaining a specific growth trend for profits. In order to achieve these goals, the management conducts fake accounting methods and simple operations.

### **3. Research method:**

#### **3.1. Sample and data:**

The population of interest comprises Saudi joint-stock companies listed in the Saudi Stock Exchange during the period from (2010) to (2014), and their number reached (169) stockholders' companies. (122) companies were selected after excluding the banking and financial services sector and the insurance sector because of their specificity in the accounting standards and financial systems in the Saudi Kingdom. (50) companies were selected as a sample from among these companies. the sample size of the current study is estimated shown in Table below:

**Table 1. Study sample according to sectors**

No.	Sector Name	Sample	Number of Sector Companies	Sample / Sector %
1	Cement sector	5	9	56
2	Petrochemical industries sector	7	13	54
3	Retail sector	4	9	44
4	Energy sector	1	1	100
5	Agriculture and food industries sector	7	13	54
6	Telecom sector	2	3	67
7	Multiple investment sectors	2	6	33
8	Industrial investment sector	8	13	62
9	Building and construction sector	7	14	50
10	The real estate development sector	3	6	50
11	Transport and communications sector	2	4	50
12	Publishing and media sector	1	2	50
13	Tourism and hotel sector	1	3	33
	Total	50	96	52

Source: author's.

### 3.2. Results of the study: Results related to Cosmetic Accounting practice and their statistical analysis:

**Table 2. Frequency and percentages of practice and non-practice companies of Cosmetic Accounting**

Year	Practice companies		Non-practice companies		Total	
	frequency	percentage	frequency	percentage	frequency	percentage
2010	13	26	37	74	50	100
2011	24	48	26	52	50	100
2012	32	64	18	36	50	100
2013	23	46	27	54	50	100
2014	21	42	29	58	50	100
Total	113	45	137	55	250	100

Source: author's.

Table No. (2) Shows the frequency and percentage of practice and non-practice of Saudi shareholder companies for Cosmetic Accounting during the years of study for the period from (2010-2014). It is noted from the above Table that there is a discrepancy between the years of study in terms of the sample companies' practice of Cosmetic Accounting, Where the highest frequency of Cosmetic Accounting practice appeared in 2012, which reached (32) cases and with (64%) of observations. Moreover, the least frequent Cosmetic Accounting practice was in 2010, which reached (13) cases, with a percentage of (26%). In comparison, the most significant frequency for not practicing Cosmetic Accounting in the same year (2010) was (37) cases. With a percentage of (74%), The year (2012) showed the lowest frequency of not practicing Cosmetic Accounting, which reached (18)

cases, with a percentage of (36%), While the percentages of Cosmetic Accounting practice varied, they were (48%), (46%), (42%), and the percentages of not practicing Cosmetic Accounting (52%), (54%), (58%) for the other years (2011, 2013, 2014) respectively.

It is noted from the above Table that the number of Saudi companies practicing Cosmetic Accounting is (113), at a percentage of (45%). In contrast, non-practicing companies are (137) companies, at a percentage of (55%). Therefore, it can be said that Saudi joint-stock companies practice Cosmetic Accounting.

### 3.3. Results of optional receivables:

The results showed in Table (3) the practice of Cosmetic Accounting by Saudi public joint-stock companies during the study period (2010-2014) through the use of optional receivables positively in order to inflate the declared profits, Where the average of the optional receivables for the sample during the study period (0.041), and standard deviation (0.058), While the highest value of the optional receivables (0.346), as for the lowest value of the optional receivables (-0.187).

On the other said, the results indicate a discrepancy in the use of optional receivables by Saudi joint-stock companies during the study period. In comparison, the average of optional receivables increased from year to year (2010-2011-2011) respectively. Then it declined in the two years (2013-2014). In the year (2010), the average of optional receivables (0.021) and the standard deviation (0.041), Which means that the sample companies in the year (2010) practiced Cosmetic Accounting upwards intending to inflate the declared profit number, the highest value of the optional receivables during the same period (0.096), while the lowest value of the optional receivables (- 0.054).

In the year (2011), the average of the optional receivables for the study sample was estimated (0.044) and the standard deviation (0.067). Therefore, in the year (2011), the sample companies followed the same strategy followed in the year (2010) by positively using the optional receivables in order to inflate the declared profit number, the highest value of the optional receivables during the same period (0.095), while the lowest value of the optional receivables (- 0.146). As for the year (2012), the average of the optional receivables for the study sample (0.065), and the standard deviation was (0.046), the highest value of the optional receivables during the same period (0.172), while the lowest value of the optional receivables (- 0.115). While the year (2013), the average of the optional receivables for the study sample (0.051), and the standard deviation was (0.067), the highest value of the optional receivables during the same period (0.346), while the lowest value of the optional receivables (- 0.187). In the year (2014), the average of the optional receivables for the study sample (0.025), and the standard deviation was (0.054), the highest value of the optional receivables during the same period (0.149), while the lowest value of the optional receivables (- 0.142). In general, all study sample companies followed the same strategy by using the optional receivables positively - upwards - to inflate the profit number.

**Table (3). Descriptive analysis of the optional receivables during the study period**

Year	Mean	Standard Deviation	Minimum	Maximum
2010	0.021	0.041	-0.054	0.096
2011	0.044	0.067	-0.146	0.295
2012	0.065	0.046	-0.115	0.172
2013	0.051	0.067	-0.187	0.346
2014	0.025	0.054	-0.142	0.149
During the study	0.041	0.058	-0.187	0.346

**Source:** author's.

According to the companies and for each year separately, the maximum and minimum of optional receivables are summarized in the following table:

**Table (4). Comparison of companies in terms of optional receivables**

optional receivables/year	2010	2011	2012	2013	2014	the highest company
The company	Packaging	Shaker	Amiantit	Jazan	Packaging	Jazan
Maximum- The optional receivables	0.096	0.295	0.172	0.346	0.149	0.346
The company	Zine	Transportation	Transportation	Transportation	Transportation	Transportation
Minimum- The optional receivables	-0.054	-0.146	-0.115	-0.187	-0.142	-0.187

**Source:** author's.

The behavior of Saudi joint-stock companies can be explained by the desire of the management of these companies towards inflating the accounting profit figure to achieve some motives, such as increasing the value of rewards and financial incentives provided to the management. Compatibility with the terms of debt contracts and job security, Financial analysts' expectations match management's expectations for expected earnings and Influencing stock prices in the market in the short term.

A comparison between average stock prices (as a dependent variable) and the extent of Cosmetic Accounting practice (as an independent variable)

Table No. (5) appears the descriptive statistics of the average share price in the Saudi Stock Exchange for the study sample for Saudi public shareholding companies during the period (2010-2014), according to the division of the sample companies into practice companies and non-practice companies to Cosmetic Accounting.



**Table(5).Comparison of average stock prices (as a dependent variable) and Cosmetic Accounting practice (as an independent variable)**

Companies practicing Cosmetic Accounting				Companies non-practicing Cosmetic Accounting		
year	frequency	med share price	standard deviation	frequency	med share price	standard deviation
2010	13	37.44	28.98	37	28.44	15.94
2011	24	41.61	24.20	26	29.86	23.15
2012	32	38.64	26.34	18	37.83	27.15
2013	23	46.68	31.35	27	46.33	34.4
2014	21	47.58	33.47	29	45.90	39.46
Total	113	42.129	29.40	137	37.34	28.72

**Source:** author's.

Generally, the average share price in the Saudi Stock Exchange between the two groups each year appeared as follows: First: - An increase in the average share price in general from one year to the next for both groups, second: - An increase in the average share price, in general, every year in companies practicing Cosmetic Accounting compared to the same year in non-practice companies, Third: The general average of stock prices increased during the study period in companies that practice Cosmetic Accounting compared to companies that do not, Where the general average in the first group was (42.19 riyals) compared to (37.43) riyals in the second group, which indicates the effect of Cosmetic Accounting practice on the share price in the Saudi stock market.

#### **4. Conclusion:**

This study aimed to discover the extent to which the Saudi joint-stock companies listed in the Saudi Stock Exchange had practiced Cosmetic Accounting during the period (2010-2014) through management's interventions in accounting measurement processes by exploiting the flexibility available to them in accounting standards. The practice of Cosmetic Accounting is highly expected in environments in which accounting standards contain great flexibility in choosing between accounting methods and policies. This flexibility creates an incentive for management to influence the declared net profit figure to achieve management objectives. The study results appeared to practice the management of the Saudi public joint-stock companies listed in the Saudi Stock Exchange to practice Cosmetic Accounting during the study period (2010-2014). It also showed that the percentage of companies practicing Cosmetic Accounting amounted to (45%) of the total sample companies. However, there has been some variation over the years. Where is the year (2010) the most petite year in practicing Cosmetic Accounting, as the number of companies practicing for it reached (13) companies, with a percentage of (26%), in contrast, the year (2012 ) was the most years in the practice of Cosmetic Accounting, which amounted to (32) A company with a percentage of (64%).

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