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ORIGINAL SCIENTIFIC PAPER

Creative Accounting in Income Statement: the Case of Entrepreneurs in Serbia



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ABSTRACT

Financial reports represent the main base for the decision-making process taken from users of financial statements. When financial statements contain wrong information, or they do not contain pieces of information at all, that can result in wrong decisions. Quality of financial reporting implies that the financial statements need to be compiled by with applicable legal, professional, and internal regulations. Creative accounting techniques include increasing or decreasing expenses, overstating assets, or early recognition of income.

The primary purpose of this paper is to identify the existence of creative financial reporting and its main techniques used by entrepreneurs in Serbia. Considering the unique way of the financial reporting of the entrepreneurs in Serbia, in the paper were analyzed income statements from ten entrepreneurs containing men and women. The research included a horizontal analysis of the income statements, sales growth index, which shows the possibility of creative accounting among the entrepreneurs and the analysis of average financial costs for five years. The central hypothesis is the existence of creative accounting, but not to create or show better results, but to show worse financial results to minimize tax liability

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Introduction

The main goal of accounting information is to provide a base for decision-making the process for both internal and external users of financial statements. This information is useful if they genuinely and accurately present the financial position and performance of the entity.

Accountings can use their knowledge, creativity to create financial statements which were desired by users by finding gaps and loopholes in the standards and laws. Moreover, managers have a significant influence on the decision-making process. Managers can have a high impact on accountants in choosing accounting policies, estimation of the life of fixed assets, selection of depreciation method, and calculation of inventories are just one of the possible ways of impact.

Creative accounting can be defined as the use of procedures and methods to manipulate with balance sheet positions and their values in the financial statements to achieve different objectives. In this process, the knowledge of the accountant is crucial (Mirdala et al., 2014). Creative accounting is not a fraud, because fraud is defined as an "act of bad faith that violates the law," while creative accounting "appeals to accounting practices derivatives from standard accounting practices" (Crenusca et al., 2016).

Manipulation in the income statement is one of the most common ways. Given the link between the balance sheet and the income statement, creative accountants often do not stop at a single report. Given the importance of the information provided by the income statement, manipulation techniques may have two different goals, increasing financial results or reducing financial results.

An entrepreneur is person who attracts risks. Entrepreneurs are not a legal entity, and they are responsible for their business with their total personal assets. The goal of their business is to create a positive financial result. In Serbia, the entrepreneurs were allowed to choose as to how to conduct their business books. Meaning there was a choice between whether they will conduct a simple or dual principle of bookkeeping. Since 2019, the existence of this option has been disabled, so entrepreneurs have to apply the principle of double-entry bookkeeping (Poresko - računovodstveni instruktor, 2018).

Data has been collected for ten female and male entrepreneurs. Income statements were analyzed for five years (2014-2018), and the results were compared between female and male entrepreneurs. One of the ways to identify possible creative accounting is horizontal analysis. In horizontal analysis, we analyzed revenue, profit, and financial expenditures over the years. As an addition, the interview was conducted with entrepreneurs about their business. The goal of this paper is to try to identify the existence of creative accounting in the income statements of entrepreneurs. The hypothesis is that entrepreneurs could use creative accounting intending to decrease business result.

The paper contains three parts, the first part examines the definition of creative accounting, the second part identifies the possible techniques of creative accounting and the third part of the paper shows the results of the research.

Literature Review

The first use of the term “creative accounting” was by Luca Pacioli in Venice. Relationship between traders in those times was recorded in the main and secondary registers. When the inconsistencies appeared most of the times, the ink was poured over the registers (Cernusca et al., 2016).

According to Remenarić et al. (2018), creative accounting represents the process of transforming accounting information and harmonizing it with the wishes of the company using loopholes in the rules. The cause of many accounting scandals, we can find in creative accounting. Balaciu et al. (2009) consider this term as “transformation of the accounting figures from what they are in accordance with the economic reality into what the managers want.”

Mirdala et al. (2014), argued that creative accounting could be positive and negative. Positive, creative accounting refers to the “beautification” of financial statements by actions that do not violate legislation, and it is also called “white” creative accounting. Creative accounting is not always illegal, but we can say that it is always unethical. With “positive” creative accounting, entrepreneurs use so-called “loopholes” in the legal or professional regulations. On the other hand, the negative of „black “creative accounting represent the violation of legal regulations.

“Creative accounting includes the use of aggressive or other questionable accounting techniques in producing the financial result which only suits

the purpose of the preparer” (Oyedokun, 2016). The main goal of creative accounting is not always creating a better financial result, and it can be the opposite, creating worse results. The goal for decreasing profit can be transferring profit to next year. Oyedokun (2016) gives an example of the writing of the asset but using it in the future creates a situation where there are no future expenses against the future revenue.

Supriya and Vidhi (2017) defined creative accounting as the aggressive use of accounting tools and methods to create a better image of the company, ignoring the accurate and objective business position and results. According to Harun Rutere et al. (2011), creative accounting uses earnings management technique to minimize tax liability.

The possibility to choose between accounting policies and the need in some companies for estimation or prediction can lead to creating a suitable environment for the development of creative accounting (Amat et al., 1999). Madan (2016) conducted a study in which was shown that a large number of respondents believe that creative accounting is legal (about 53% of respondents), but on the other side 45% of the respondents believe that creative accounting is illegal. If we consider who is behind the creative accounting, or earning management, how is called in the USA, most of the respondents agreed that accountants and managers are one to blame.

Tassadaq and Malik (2015) analyzed how to reduce creative accounting in firms. About 30% of respondents were an opinion that the company needs to improve its accounting standards; 45% stated the importance of audits and the rest of the respondents agreed on increasing the punishment. As an answer to a question who suffers from loss due to creative accounting, most of the respondents agreed that investors suffer the most. According to Tassadaq and Malik (2015), ethical environment plays a significant role in decreasing manipulative behaviors in companies.

When we think about the term "Creative Accounting, “we always picture it unethical. However, Butt et al. (2011) have a different point of view. They argued that creative accounting is not always wrong and if “used correctly, it can be of great benefit to the user.” In the research, they mentioned the example of Pakistan's cement industry. Pakistan’s government had an incentive plan for the cement industry. However, the country's economy got into bad shape, and it did not have enough resources to proceed with the incentives. Therefore, companies used creative accounting to show better results, lower the losses, and keep investors. After that situation had changed, demand rose, and it eventually led to capacity expansion. Moreover, Butt et

al. (2011) defined creative accounting as a tool that represents the use of accounting standards and policies to show the results of the company in line with managers wishes.

Research in Britain has shown that manipulations are usually implemented with the provisions, revenues, and expenditures. According to Belak (2011), if in Croatia were conducted similar research, the result would be similar.

According to Škarić-Jovanović (2007), the goal of creative accounting is achieved if users of financial reports do not realize that manipulation has been performed and they believe that the report presents objectively and accurately the financial position and performance of the company. When discovering manipulation, it is necessary to analyze the accounting policies and quality management. Škarić-Jovanović (2007) also stated that creative accounting is conventional in developing economies with a large share of the "gray economy." In the Balkan countries, tax evasion was perceived as a normal phenomenon; however, nowadays, this point of view is changing.

We distinguish three types of taxation of entrepreneurs: flat rate, the self-taxation system with the payment of personal earnings and self-taxation without the payment of personal earnings. In this research, we will focus on the entrepreneurs' which use self-taxation system regardless of the payment of personal earnings. The primary purpose of the tax is to enable the government to fund different types of programs. However, tax evasion makes this impossible. It can be stated that tax evasion represents the major problem of one country.

The purpose of the financial statements is to represent the base for the decision-making process for external interest groups; creative accounting can appear because of the existence of too many options in legal or professional regulation. Within the research, the opinion of bookkeepers in Serbia about creative accounting was examined. The result showed that half of the respondents think that creative accounting represents the use of techniques and methods within the framework of regulations." (Mirdala et al., 2014).

The quality of financial reporting in the Republic of Serbia is at a very low level. The main reasons are the non-harmonization with the regulatory framework of the European Union, the legal regulations in the Republic of Serbia do not follow the best practice defined and advised by the profession, and the issue of accounting ethics can be ignored entirely, as can be seen from the previously mentioned research where most professional bookkeepers think that creative accounting is one of the uses of techniques and meth-

ods that are within the framework of regulations. Stanojević (2016) believes that the quality, or better the lack of financial reporting in Serbia, is influenced by the fact that IFAC is not included in the legal framework of the Republic of Serbia. However, there was made an effort towards harmonization of the accounting system in the European Union.

Nowadays, the theory that claims that large companies have a significant impact on the national economy has been abandoned. The significant influence on the economy's growth has small-medium enterprises and entrepreneurs. Petrović (2019) has stated that entrepreneur's sector in Serbia contributes about 30% of GDP. According to Petrović (2019), Serbia should improve the environment for entrepreneurial growth to create better economic development. Entrepreneurs have unique characteristics that are reflected in the ability to take over the risk, the ability to transform their dreams into a plan that can be realized, they are the bearers of change and innovation (Stašević, 2018). Radović-Marković et al. (2019) stated that entrepreneurial activities are usually connected to an individual who appears to be a leader. An entrepreneur is described as "the driver of an entrepreneurial initiative and organizer and manager of operational processes."

Manipulative Techniques in Income Statement

One of the leading accounting goals is to provide information that is fair and objective. The creative accounting can be linked to the existence of various options whose primary goal is to improve or increase the information power of financial reporting through the introduction of the concept of fair value and other models. However, many saw this option as a possibility of permitted manipulation to create the desired performance. The income statement is one of the financial statements that confront income and expenditure.

Dimitrijević (2018) defined four possible ways of manipulations in the income statement: increasing revenue and decreasing expenditures aiming at creating better results, or increasing expenditures and decreasing revenue as a goal to generate worse results of the company.

Increase in revenue through recognition of non-existent revenues, double-entry, income infusion, and others. This technique aims to generate a fictive positive financial result. Since income represents the most crucial part of the income statement, that makes it the most vulnerable. One of the ways to increase income is early recognition of income. IAS 18- Income de-

defines the circumstances which should be met to recognize the company's income. "Revenue is recognized when it is probable that future economic benefits will flow to the entity, and those benefits can be measured reliably" (IAS-18). As an example of a fictitious increase in income, invoicing of the service or goods at the end of December, and then the cancelation of the same invoice in January next year. The described technique is called window dressing, whose main goal is increased profitability and liquidity in the financial statements (Oyedokun, 2016). One of the exciting ways of creating income can be the use of loans from the founders. Renouncing the founders' loan can increase the income, which is frequently used in the praxis — renouncing the loan lead to creating the extraordinary income in the income statement of the entrepreneurs which in most cases create a positive financial result. These types of extraordinary income cannot be connected with cash flows, which makes them suitable for so-called „soft” manipulations. „Soft” manipulations are not real criminal acts; they are just a way to create a desirable financial result (Belak, 2011). In profit smoothing technique, the company recognizes some fabricated assets or liabilities and then use them to increase or decrease profit (Oyedokun, 2016). Namely, revenue-raising techniques are most often used by entrepreneurs in search of external sources of funding (applying for loans of various uses).

Reduction of revenues is usually made through various techniques such as sales through „black” market, avoiding to invoice or using the technique of partial invoicing, transferring revenues in the next year, etc. Introducing the sales tax, the space for manipulation has drastically decreased. As an extremely vulnerable transaction, we can classify transactions with related parties. For both entrepreneurs and even legal entities, transactions with related parties may be one of the possible and most common forms of manipulation. Manipulation can be carried out through product placement at lower prices to influence sales revenue to show a lower financial result. The opposite way is to sell at higher prices to show the achieved result higher than it is. The fact that entrepreneurs are not mandatory to compile a report about transfer prices opens an additional opportunity to manipulate them. The decrease in income is most common in the case of entrepreneurs toward a reduction in tax obligations.

Increasing expenditures fictively has a goal to reduce taxable profits. The most common example is the recognition of private expenses of entrepreneurs as the expense of entrepreneurial activity. Namely, through the purchase of personal resources for entrepreneurial activity, an entrepreneur

achieves “fitness,” reducing the amount of taxable profit by calculating depreciation on the purchased asset. Big bath accounting is described as recognizing all bad news in one year and then making the company stronger in the following years. This technique means writing off assets than using it in the following years, recognizing liabilities (Oyedokun, 2016). Cookie Jar Reserves technique is used to transfer the amount of positive business result into the next year (Butt et al., 2011). Also, one of the methods of reducing taxable profit may be the recording of fictitious amounts of expenditures, fraudulent accounts.

Expenditures reduction is an act of creative financial accounting aimed at increasing the profit of entrepreneurs. The most common goal is the presentation of better performance of the entrepreneurial business results to obtain more favorable sources of financing (short-term and other types of loans). Reduction of expenditures is encouraged by the prolonged depreciation calculation, through poor timing of expenditures, recognition, or transfer of “December” expenditures in the next year (Dimitrijević, 2018).

Income statement contains the essential information about the business of entrepreneurs, that makes it the most vulnerable to manipulation. The most common goals of manipulation in the income statement are decreasing business results or showing business perform better than it is.

The aim for false improvement in the performance of the entrepreneurial activity, creation of an artificial positive financial result is usually to obtain external sources of financing or to achieve more favorable conditions in terms of the lower interest rate. Škarić-Jovanović (2007) stated that creative accounting could eliminate the threat of the loans which were already received. When applying for external financial sources of financing, it is necessary to show stability in income which is done by various methods of inflating revenues in the form of early recognition, showing non-existent or even transferring non-business revenues into incomes which were realized in the regular business of entrepreneurs.

However, reduction of the positive financial result has a goal, to the manipulation of taxable profit to the acceptable amount for the entrepreneur. The aim of this action is the lower monthly payment of the tax rate. Manipulating with the profit tax can be legal on the one hand, while on the other hand, it is illegal. Legal manipulation of taxable profit is defined as “the full use of all options for reducing the tax liability provided by the law” (Dimitrijević, 2018). Illegal manipulation of the profit tax can be defined as a failure to pay or avoid payment of a statutory tax.

It should be noted that the boundary between these two categories is fragile. Škarić-Jovanović (2007) agreed that one of the oldest and most common motives for using creative accounting could be tax evasion. That provides the company a way to „acquires a non-interest-free and non-taxable source of funding.”

Creative Accounting with Entrepreneurs in Serbia

Research Methodology and Data

The research included five female entrepreneurs and five male entrepreneurs. The income statements were analyzed from 2014 to 2018. As an addition to the analysis of the income statement, the interview was conducted with the entrepreneurs. Data from income statements were collected during the interview.

The analyzed entrepreneurs deal mainly with trade and service activities such as hospitality service. Most of the female entrepreneurs deal with small trade business and catering facilities. Male entrepreneurs deal with services and trade too. Female entrepreneurs represent a vulnerable group in the labor market; the focus of the research will be on the analysis of their business.

The research included an analysis of average income, average profit, average financial costs, and sales growth index. Sales growth index can show the possible use of creative accounting in the income statements of entrepreneurs. Sales growth index was calculated from the data in income statements, and it represents the ratio of the income (Belak, 2011).

$$\text{Sales growth index} = \frac{i}{i_{-1}} \quad (1)$$

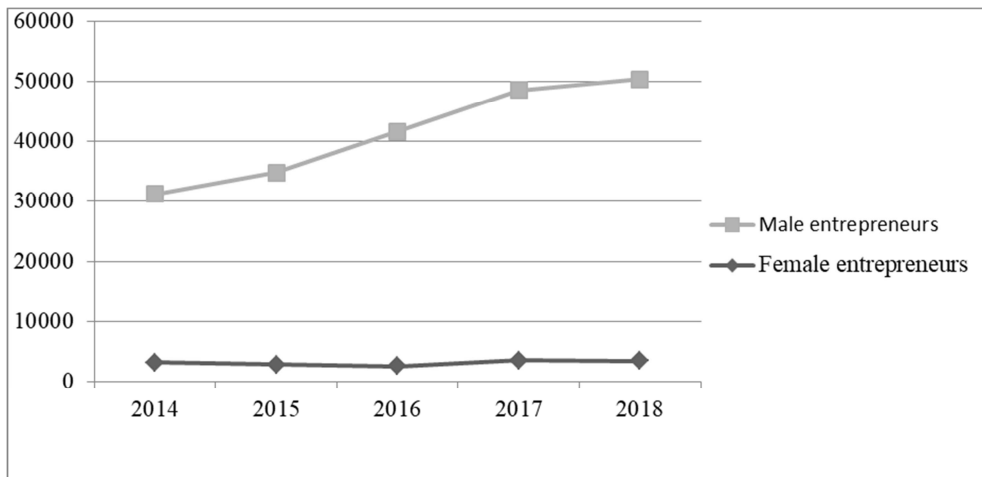
With horizontal analysis, we were able to identify the possible use of creative accounting. Illogical movements and deviations through the years of individual items can be one of the signs of manipulation in the financial statements.

From 2019 there was a reduced possibility of choosing between two principles of bookkeeping; the author believes that there will be a reduction in the possibility of creative financial accounting within the entrepreneurs.

Research Results

Searching for the traces of creative accounting can be done by analyzing the quality of profit and income through the years. During the interview, most of the female entrepreneurs stated that they prefer stable business and that they do not prefer taking loans. They mentioned that they think if it would be desirable that there are some of the incentive measures for the development of the female entrepreneurship from the government, as well as the better information about programs. However, male entrepreneurs are more goals orientated, and they prefer taking loans. Figure 1 shows the analysis of average income for entrepreneurs. The average income of the female entrepreneur is stable in the observed period. As an explanation of this result, it can be stated that male entrepreneurs tend to be riskier, while female entrepreneurs choose a more secure way of business and choose stability.

Figure 1: Analysis of average income (in 000 RSD)



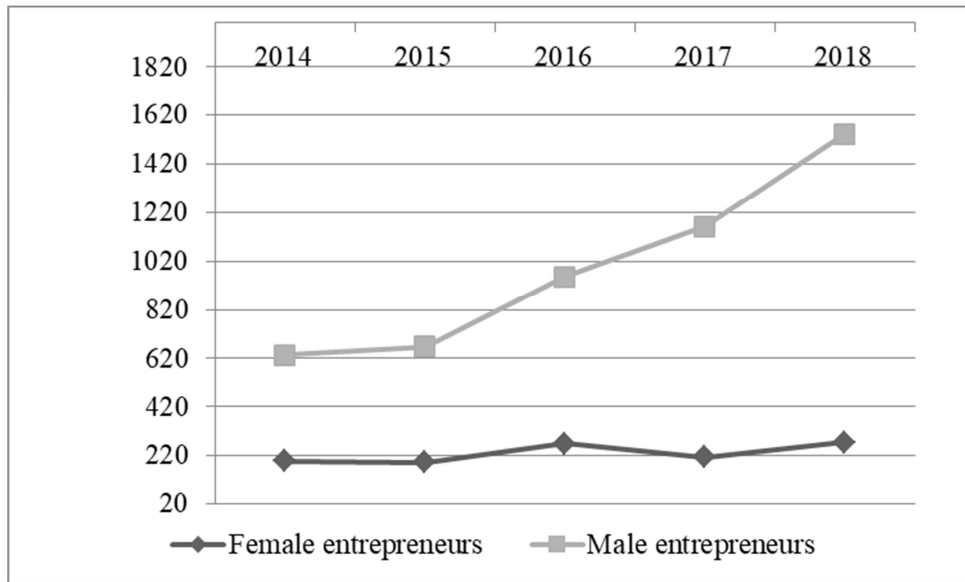
Source: Authors based on research results

The research that was conducted by Dechow et al. has shown that most of the companies that used techniques of creative accounting manipulated with the income. Just 11.5% of the companies used expenditures (Škarić-Jovanović, 2007).

When using creative accounting, many entrepreneurs in Serbia tend to manipulate with profit, mostly in decreasing the profit. In figure 2 is shown

the analysis of average profit. Movement of the average profit is similar to the average income. Moreover, in this case, we can notice that male entrepreneurs have a higher average income, while the average profit for female entrepreneurs is relatively stable over the years, although in 2017 there was a slight decline.

Figure 2: Analysis of average profit (in 000 RSD)



Source: Authors based on research results

Sales Growth Index (SGI) is calculated as a ratio of income, and it shows the possibility of manipulation in financial statements. When sales growth index is higher than 1.134, it shows a probability of manipulation in financial statements (Belak, 2011). However, if the financial statement is manipulated for several years in a row, this way of analysis will not be realistic.

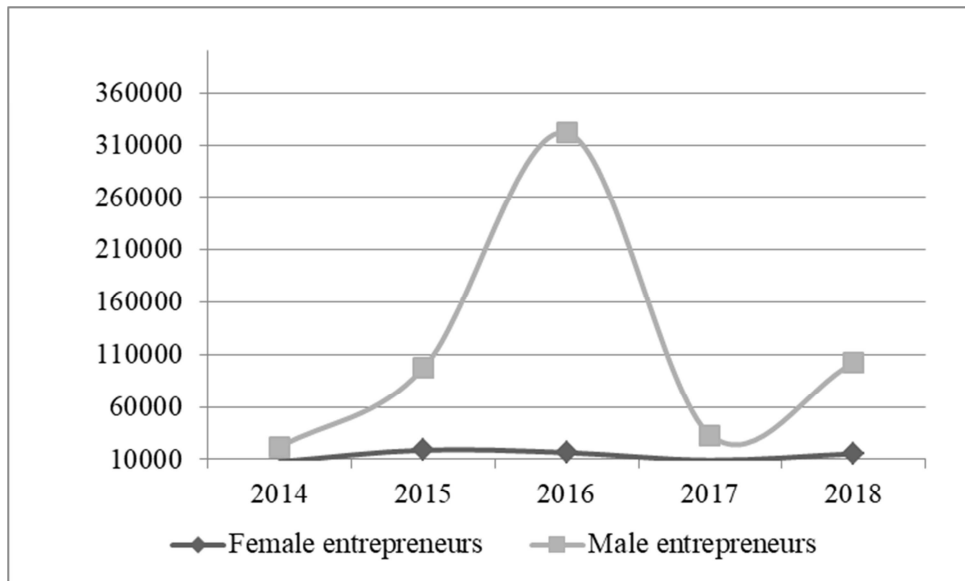
SGI in 2014/2015 and 2015/2016 was higher than the critical value, and there is a slight possibility that income statements were manipulated. The highest value of SGI for observed entrepreneurs was in 2016/2017 (76.52). During the interview, the entrepreneur explained that in 2016, she had only been in business for several months due to personal reasons. In 2017 she began to do business as usual.

Table 1: Sales Growth Index

Sales Growth Index	2014/2015	2015/2016	2016/2017	2017/2018
MALE ENTRE- PRENUALS	1.22	1.36	1.16	1.10
	1.01	0.96	0.96	0.96
	1.61	0.62	1.06	1.25
	0.79	1.34	1.52	0.55
	0.92	0.99	1.05	1.05
FEMALE ENTRE- PRENUALS	8.19	1.28	1.04	0.63
	1.32	1.33	1.04	1.12
	1.50	0.87	0.94	0.84
	0.85	0.17	76.52	1.14
	0.73	0.73	1.10	1.03

Source: Authors based on research results

Figure 3: Analysis of average financing costs



Source: Authors based on research results

Average financing costs can show a tendency for risks, the desire for business growth, but it can also imply the dependence of external sources of funding. Figure 3 shows the movement of the average financing costs for female entrepreneurs and male entrepreneurs.

Average financial costs for female entrepreneurs were stable over the years. However, average financing costs for male entrepreneurs in the first two years significantly rose, but in 2017, there was a significant decrease.

Conclusion

In the last decades of the previous century, even in the early 2000s, we witnessed numerous financial scandals that hit the world. As a result of manipulation, there was a significant loss in confidence in financial reporting. The main goal of financial statements is to provide objective information for external users. Creative accounting leads to the loss of the information in the financial statements, the creation of hidden reserves or latent losses. This kind of financial reporting undermines the entire purpose of financial reporting. Creative accounting can be defined as the deliberate use of knowledge of the accountant to present the desired financial status. Entrepreneurs can use creative accounting to magnify their business results when applying for external sources of financing. The reasons for magnifying results can be a lower interest rate. However, entrepreneurs can show their business results worse than they are to minimize tax liability.

In the research, we compared the business of the male and female entrepreneurs, and authors have concluded that male entrepreneurs accept the bigger risk, which eventually led to a higher positive financial result. Male entrepreneurs have more significant average income and average profit in the observed period than female entrepreneurs. In the 2014/2015 and 2015/2016, the value of SGI was higher than the critical value meaning that there is a possibility of the use of creative accounting. However, there is an equal possibility of implementation of creative accounting, between female and male entrepreneurs.

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