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Manipulating user behavior through accounting information

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Abstract

The financial reporting based on accounting principles should give a true and fair view of the business reality. But sometimes, the accounting information is handled; therefore users' behavior is manipulated. The accounting managers, who control the form and content of the financial statements issued by corporation, will make sure that these portray a picture that is favorable to them. The main objective of financial reporting must be to provide valuable information to users. So, when deciding the content of the financial statements, the information needs of the users should be taken into consideration. These needs may be assessed by analyzing their decisions for which the accounting information may prove to be helpful. In this study we analyze the techniques used for the manipulation of accounting information and we propose different solutions in order to mitigate them. The paper also presents an overview of the concept – although an exact definition was not established so far, many authors tried to give an explanation for this phenomenon.

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1. Introduction

An irony of our times may be that although hundreds of satellites monitor the planet, although we see a widespread use of information technology, allowing the collection, accumulation, transmission and processing of an impressive amount of data, still the accuracy of economic and financial data reporting remains dependent

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to the referential reporting data and the "handling" techniques of the results. Despite multiple sources of information, at the same time, the reflection of financial accounting information remains the main source of economic activity and the result of these activities for both, entities and their managers and even for the great diversity of third parties: suppliers, customers, employees, investors, banks state institutions, etc [1].

Although it is sometimes considered science and sometimes art, accounting has managed to gain reliability in the economic world. The ones that do not understand it, can easily imagine that accounting is a very exact science, similar to mathematics. In reality, the accounting information is neither simple nor precise and rarely meets all requirements of the various users [1].

2. General considerations on creative accounting

Accounting can be considered as representing the company's life, based on principles, norms and judgment. The purpose of the enterprise accounting representation is the preparation and presentation of annual financial statements, which should provide the users of accounting information, a more accurate picture of activity. However, there are plenty of situations where users can be influenced one way or another, by presenting distorted accounting images and thus their behavior can be manipulated. Introducing artificial accounting images increases the information asymmetry and influences the functioning of financial markets [1].

In this respect, the FASB (Financial Accounting Standards Board) states that: "The information provided by financial reports is often the result of approximate rather than precise quantification. Quantification usually involves numerous estimates, classifications, integrations, reasoning and systematization. Product business in a dynamic economy is uncertain and results from a combinations of several factors. Thus, despite the impression of precision which creates financial reports, with few exceptions, quantification is approximations that may be based on the rules and conventions rather than exact amounts."

As a result of the uncertainties inherent in the activities, many financial statement items cannot be measured precisely, but they can only be estimated. The estimation process involves judgments based on the latest available and credible information. For example, estimates may be required in relation to: bad debts, stock's moral depreciation, the fair value of financial assets and liabilities, the useful life of the asset and the expected pattern of consumption of economic benefits for depreciable assets, liabilities arising from guarantees, and so on.

The specialized press has shown a series of cases of handling user behavior through dissimulated accounting information which ultimately ended with major financial scandals. Examples include: energy company Enron, which went bankrupt soon after discovering irregularities in December 2001 (the firm dissembled a total amount of 27 billion U.S. dollars), the telecommunications company WorldCom, which has inflated cash flow with almost 4 billion U.S. dollars and the discovery of financial fraud of global manufacturer of copiers Xerox (in July 2002) that illegally increased its turnover with approximately 2 billion U.S. dollars in 1997-2001.

According to latest research, the management of these companies was very well informed about the real situation and moreover, large audit firms like Arthur Andersen (now taken over by KPMG) that audited financial statements of the mentioned companies. Along with these financial scandals, it is almost natural that the investors' and other users' confidence fall apart. Even if accounting manipulations do not involve cases of bankruptcy, they will surely have a certain future effect - low credibility of information will lead to additional costs in future periods (loans with higher interest rates, for example). We might consider that this entire situation occurred because nowadays, appearance seems to be more important than real existence. In this context, accounting can be referred to as "the salesman of economic performance for the enterprise" [2].

Over time, accounting has been treated as an art – "the art of fake or trick stock" [3], "the art of calculating benefits" [4], "the art of presenting a balance sheet" [5], "the art to create provisions" [6]. "Engineering accounting" is a less common word in literature, it is usually titled creative accounting and it is subject to a vast literature in the past 20 years. The use of this concept shows a possible association with creative work, design, research, management of “technological processes” by accountants, resulting in a favorable image, desired by the company.

Actually, the term “engineering accounting” creates the illusion of a more favorable situation for the financial position and performance of the entity. At this level, engineering accounting has led to a number of accounting scandals and the proposals for ‘accounting reform’ usually focuses on the latest analysis of capital and inputs that reflect the real added value. Regardless of its name, engineering or creative accounting, it refers to accounting practices determined by accounting practices. These are characterized by excessive complication and creativity similar to writing a novel, aimed at presenting favorable financial position and performance of the company. Financial statements obtained this way are not boring, but rather have all the complexity of a novel, and that is why it is called “creative” or “innovative”.

Handling users’ behavior through accounting information - by providing the desired image of company managers, does not necessarily mean a violation of the accounting rules and regulations. It can rather be done within the limits of the law. Despite the increasing importance of the synthetic documents and the complexity of business developed by normalization, accounting information fails to meet the full functions assigned to them. The most obvious evidence is financial scandals. They are based on the discovery of fakes or dissimulation techniques to actual situation, phenomenon known as ‘creative accounting’. The term was first used in Anglo-Saxon accounting, and was subsequently introduced in the accounting world. The literature includes many definitions for creative accounting, but a standard statement is not yet established.

The most relevant definition for creative accounting belongs to Naser, according to which creative accounting is: “1) the process whereby, given the existence of gaps in the rules, it helps to manipulate accounting numbers and taking advantage of the flexibility, those practices are chosen for measurement and disclosure of the summaries that allow the transformation of what they should be what managers want, 2) the process by which the transactions are structured in such a way as to allow the “production” of desired accounting result” [7].

In a synthesis of the various opinions regarding creative accounting, we can state that the use of specific accounting practices, which are actually legal can allow the company to provide the desired image. We must distinguish between manipulation of accounting information within the limits of the law, also known as creative accounting and manipulation of accounting information flouting accounting rules that means in fact, accounting fraud. Even though such manipulations respect the letter of the law, in reality, they violate the spirit of it. The ultimate goal behind the distortion of financial position and results of a company is to mislead investors [8].

Creative accounting may be caused by loopholes in accounting rules or, sometimes, accountants are oriented towards certain professional subjective judgments even under accounting rules. For example, the General framework for the preparation and presentation of financial statements states that when applying a rule might not ensure a true image for the financial state of a company, exceptions can be made in order to correctly reflect the reality. The basis for this reasoning will consequently be professional judgment.

Many of us may have wondered whether accounting fraud and engineering are two synonym terms. At first, the answer would probably be “no”. Fraud is bad-faith action that will violate the law, it is a bad practice, while the accounting engineering means respecting the law, but not its spirit. Although different, presented approaches have a common denominator, namely the fact that engineering accounting is legal and aims at creating a distorted image of the company by presenting a more attractive and misleading image for investors. Still, a clear demarcation can be made between creative accounting and accounting fraud. “Developing creative accounting in her perverse side, favored by the loopholes of accounting rules, make it difficult or even impossible to assess the actual situation of the enterprise and produce a serious alteration of accounting truth” [9].

In conclusion, we can state that creative accounting is a set of engineering processes which aim to change the financial result in order to optimize the image reflected by financial statements. The procedures used are based upon choices permitted by accounting rules, open possibilities determined by the deficiencies of accounting standards, and accounting mechanisms that can occur: determination of accounting interpretation of legal and financial transactions or development of a legal and financial mechanism in order to change the outcome or financial statements.

3. Factors of development for creative accounting

Financial statements are identified as "victims" and creative accounting as "the murder weapon". The only thing that is missing is the reason. Such factors that determine managers to use these techniques are:

- The costs resulting from the conflict of interest. According to the positive theories, any contract is associated with costs. It explains the differences between the accounting procedures used by companies and the moment of adoption of certain specific accounting procedures. Accounting procedures may affect the degree liquidity of the company through a political process. The political process represents a competition between individuals regarding the transfer of wealth. Thus, it is possible that, in order to avoid pressures from the Government and to increase subsidies given to the company, managers to choose accounting procedures that reduce profits.
- Incompetence managers. Incompetent managers focuses on private arrangements and neglect information system accounting and financial rates that begin to deteriorate. A society undoubtedly reached this stage begin to use creative accounting. The motivation is obvious. Since the company has not achieved satisfactory performance, it is possible that suppliers do not grant trade credit, lenders to reduce loan repayment deadlines, clients to seek other suppliers. Using creative accounting, managers adopt a defensive position. Their refusal to accept failure is a possible component of normal psychological attitude that the clouds are going to bump into each other. It can be concluded that creative accounting can sometimes be associated with failure, the company uses to postpone the "fatal" day.
- Uncertainty and risk. According to Goodfellow, using creative accounting is the result of increasing the volatility of some of the elements of the market [10]. Thus, the transition from constant currency from fluctuating exchange rates, interest rates, growth correlated with increasing inflation rate, has resulted in increased uncertainty. In such situations, companies are motivated to adopt risk mitigation tools. The problem results from the fact that the normalization of accounting representation known is consistently delayed with respect to these instruments.
- The variety of economic activities. Extremely varied nature of economic activities requires a number of particularities in terms of their assessment. Therefore, to represent better the image of a given activity is necessary to provide a margin of freedom. This freedom is reflected by the existence of evaluation operations. Using options, although legitimate, allows enterprises to "pave" the results.
- The attitude of the users of financial and accounting information. It is believed that even users of financial statements can help to use creative accounting through excessive importance given to accounting result. The fact that in general investors seeking stable earnings growth, encourages companies to "smoothing" the performances to satisfy their demands. Specifically, dividends and establishment of reserve impact the share price because they provide investors with information about future profitability and, therefore, it has an effect on the share price. It becomes obvious that if the managers want to increase the price action and creative accounting can help, it is an attractive technique.

4. Types of creative accounting techniques

The most common creative accounting practices aim at influencing the level of results and changing the indebtedness rate. In the literature, these are grouped into three categories: techniques that influence the income statement, the balance sheet and techniques that misrepresent the information from the notes to the financial statements.

One of the most challenging cases is given by the “smoothing” of the results. It is a practice which seeks to reduce fluctuations accounting results. Also, such a practice can ensure a constant level of results over several years. In order to “smooth” the results, there are generally three techniques. The first one requires to stagger current operations to reduce variations in profit over time. A second technique involves allocating costs and calculated revenues, in time. Appropriate choice of the duration of use. A third technique involves changing the classification of items in the income statement. In this way, all the results of the company may be subject to a certain “smooth”: the net result, outcome or the result of operations before taxation.

4.1. Techniques that affect the income statement

Creative accounting techniques that affect income statement, respectively accounting result that targets the changing of it, in growth, reducing or maintaining, within certain limits. The growth accounting result can be followed by managers in order to influence the financial market, especially when there are following a new issue of shares to increase its remuneration they deserve (which is determined by profit) or to be in agreement with the predictions of financial analysts regarding the estimated size of the result. Then, there are enough cases where managers want to submit an accounting result decreased, namely: when they want to reduce their tax base to pay less tax, if they want to buy the shares themselves, is to reduce their price if they don't want to attract attention of the unions do not want to draw attention seeking higher wages or public authorities that may require certain sponsorship. Also, there are businesses that resort to a policy of smoothing of the result, considering that its fluctuations are interpreted by investors as a risk factor. These are examples of situations that cause managers to embellish the size of accounting result. Next, we will make a thorough presentation of the techniques of arranging the result in the desired direction.

Calculated expenses and revenues as the amortization and provisions does not imply cash flows, but only changes the accounting result in one direction or another. Depreciable value of an asset, residual value, choosing the length of useful life are based on professional judgments, what they print a subjective character, thus generating different results. Then there are the cases in which an asset depreciation is included in the value of another asset, according to IAS 2 “Inventories”, which change the size of the accounting result at a time. Mitigation in the embellishment of the result besides depreciation is generated by the application of international accounting standards, IAS 12 “Income Taxes”, which requires the registration of temporary differences (deductible or taxable) between tax depreciation and accounting depreciation.

In addition to depreciation even provision influence the size of the result, either by omitting to set them on the grounds that they are not deductible from the tax point of view, either by their excessive creation in a period in order to increase revenue in a future period. For example, in case of changing management, the new leadership wants to incorporate provisions to reveal the improper management of the previous manager, and in a future period revenues increase can print to the users the effective of the management accounting information (a less careful analysis of the situation).

Amortization value of an asset should be allocated symmetrically throughout the useful life of that asset. Usually depreciation method chosen is that which reflects the rate at which future economic benefits has consumed due to the use of that asset. Companies are taking the opportunity to choose different amortization methods leading, most often, to different results.

The subjective increase or decrease of revenue and expenses can be made through anticipated costs and revenues, of the various ways of accounting for revenue related to construction contracts, of the anticipation supplies of products which will be carried out only in the next financial exercise etc. An example in this case concerns the depreciation of receivables and the mitigation of their losses.

According to IAS 16 “Tangible assets”, the costs of tangible components replaced, can be recognized in the accounting value of the tangible asset even if the replacement has an non-current character, it is possible to generate future economic benefits to the entity related to the asset and the cost of the asset can be measured in a credible way.

Overvaluation or undervaluation of asset items whose values are estimated based on cost is practiced by businesses management to get different results, so they can choose between a full or partial cost asset valuation. In this regard, according to IAS 2 “Inventories”, the costs of purchasing stocks may affect whether or not the cost thereof, as shall obtain different results in accounting treatments recommended by IAS 2 out of stock assessment or giving out in consumption. A similar situation marked by subjectivity, occurs in the case of assets. According to IAS 16 “Tangible assets”, subsequent expenses increases the value of assets to the extent that they replace certain parts of these assets. The result will be affected depending on whether or not such expenses are capitalized.

Accounting treatments when we take in the view the evaluation of the stocks recommended by IAS 2 “Inventories” are “exploited” by the creativity in the art to provide a more attractive result. According to IAS 2, the cost of acquisition shall include the purchase price, import duties and other taxes (except that the company may recover from the taxing authorities), and transport costs, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Depending on the desired result, the costs of buying stocks will be manipulated.

Regarding interest capitalization, this is a practice that allows the enterprise to include the expenses in the costs of assets, according with IAS 23 “Borrowing costs”. Of course, in this case, the interest expenses will not be charged to the current result, but will be transferred to the next financial exercise. IAS 2 “Inventories” indicates that the cost of inventories may be included in the borrowing costs. Capitalization of borrowing costs is provided in IAS 23 “Borrowing costs” through the alternative treatment allowed, available in the case of inventories that require a substantial period of time to get ready for use or sales.

Lease-back is the operation whereby an asset is transferred to another part, then it is assumed in operational or financial leasing. Thus, the company will establish an income at the sales moment which will increase the result. Over the time, it is neutralized by the value of the paid rents, but at the moment of the transfer, the profit increases. Then, if is about an operational leasing, will not be affected nor the debts of the enterprise.

The perfect prices at which goods or services are transferred between entities that are belonging to the same group, are increased or reduced depending on the interests pursued. For example, benefits can be transferred by companies located in countries with a high tax to firms with offices in countries with a low taxation or tax havens.

All these practices that may be used by enterprise management demonstrates that the economic result do not shows any economic significance, and its use, especially in situations of financial analysis, must be avoided [11]. If accountants are not so interested in the size of the profit, because anyway, is a relative concept, not the same thing we can say about the financial analysts, who will doubt the correctness of results taken into account in the determination of financial indicators. An improvement of all these cosmetic of the outcome can be obtained in time, if we consider, as some authors emphasize that “any vested result enjoyed forever to appear sooner or later, as a final exercise stock becomes the initial stock of the following exercise, so that an enterprise cannot endlessly manipulate the outcome” [12].

4.2. Techniques that affect the balance sheet

Besides adjustment the accountant outcome, the manipulation techniques of economic reality of an entity take into account and balance sheet. Most policies relating to balance sheet are considering most of all the increasing of the capital, to adjust the borrowing rate. Here are a few of the techniques that adjust of balance sheet size.

Revaluation of assets may sometimes be necessary to increase prices, resulting in a less reliable presentation of assets. But there aren't few cases when firms are using the revaluation of fixed assets in order to raise the capital. Then, this had incidence in the amortization base, depreciation period, for this last one existing the opportunity to be changed; all these adjustments are contributing to the arranged balance sheet. Then, the revaluation of assets is a practice often used by firms in difficulty, in order to improve performances reflected through changes in the capital situation.

Although the process of re-evaluation of the tangible assets is a normal one, this technique can improve your company's financial performance. Many companies resort to this accounting policy, as the last chance to improve performance reflected through changes in the capital situation.

According to international accounting rules, fixed assets may be subject to an economic exchange. The cost of the received asset will be given by the fair value of the transferred asset, adjusted by the amount of any sum transferred. Fair value estimate can be done in such a way for the transferred assets that can be accounted a loss of value that will affect the value of the new asset.

The manifestation of the creative accounting can be found also for development expenses. Although, IAS 38 "Intangible Assets", specifies clearly when these costs are taking in consideration, however there are situations in the practice of accounting or not these costs to the exercise result, without making a clear delimitation between the research phase, which can affect the result and the development phase, when the balance sheet will be influenced.

Another way of manipulating accounting numbers can occur in the case of financial arrangements, known in the literature under the name "non - indebtedness in fact". This technique involves the transfer of receivables to another company, provided that it takes over a portion of the debt. Legally, the company still remains the principal debtor, without being absolved of paying of the debts. That is, in fact, the reason for using this technique.

5. Instead of conclusions … ways of detecting engineering accounting

So, having regard all of these misrepresentations of the financial statements content through creative accounting, we were wondering what would be the ways of detecting these manipulations, but also to prevent the financial performance of companies "makeover"?

An effective way of detecting engineering accounting involves the comparison of cash flows arising from operating activities with the net income generated by this activity. Normally, these are directly proportional. If there is noticed an increase in earnings associated with a decrease of cash flows, we cannot say for sure that it is the effect of the creative accounting, but surely those interested must expect a decrease of future gains.

The appearance of an Accounting Framework it was considered that will solve the problem, but managers and accountants have found enough "wickets" manifestation of creative accounting. Therefore, it is not enough only the existence of a Conceptual Accounting Framework, whatever it is, a solution in terms of combating creativity would be to improve accounting conceptualization and normalization. A way to improve the normalization is considering reducing the accounting options for the same problem. However, you don't have to arrive at an excessive rigidity of the accounting rules so that accountants do not have the opportunity to find the best solution for the reflection of reality in an issue. Specifically, accounting theory in general, and not the norm, which refers to specific aspects, must be designed in such a way to meet practical needs as well as possible. "In the absence or insufficiency of the accounting rules, a good accounting theory allows for the reflection of reality with a reasonable dose of subjectivity, while having an accounting solutions based only on professional judgment, without a solid conceptual support is sometimes leading to a debatable solution, with a large dose of subjectivity after the accounting experience" [9].

The international scandals of Enron, Parmalat and Xerox had raised the attention of international regulatory organization, on preventing accounting engineering of the enterprise performance. Thus, recently, it was elaborated an international norm that regulates the introduction of a new cost to the enterprise, payment based on actions, named IFRS 2 “Share-based Payments”. This is a transaction in which the entity receives or acquires goods or services as consideration for equity for the capital instruments or through debts for amounts based on the price of the shares or other capital instruments of the company.

Another solution in ensuring a fair and real images of an enterprise through imaginative accounting control refers to the professional deontology, ethics, applied to a specific professional field; in our case it’s both about the professional ethics of accounting (accounting information production), as well as about the ethics of auditing (accounting information quality). The objective of the measures to combat accounting creativity consists in providing quality information that establishes the best decisions for their users.

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