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Embellishment of financial statements through creative accounting policies and options

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Abstract

Economic, legal and social developments, and also the pressure of information users have made accounting innovation a necessity, thus resulting accounting creativity.Discussed from the accounting specialists' point of view, creative accounting was supported by basic and alternative treatments used to solve the same problem.**In most cases an accounting problem has at least two solutions, with a different effect on the financial position and enterprise performances.**The occurrence of creative accounting was influenced by the flexibility of international accounting regulations.In most cases, creative accounting is seen as a negative creation, meant to lead to compiling financial statements that would answer managers' wishes regarding the financial position and enterprise performance.

Keywords: creative accounting, financial statements, enterprise performance, creative accounting practices, result shaping

1. Introduction

Business globalization creates new challenges for accountants, faced with new expressions of firms' identities always in competition, on an enhanced market where the need for information is diversified and much quicker, resulting, sometimes, in a marketing and publicity instrument. In this context, the accountant has to find quick solutions to adjust to the new requirements, sometimes without waiting for standardization, thus establishing the need for creativity, to look for other solutions or treatments that promote company image and gaining an advantage without interfering with the law.

The existence of all sorts of uncertainties, both economic and accounting, in the environment of the enterprise, makes financial statements to be only estimated not properly measured. The management option for one of this treatments and accounting policies creates the possibility to choose a solution on purpose for the best of the enterprise, but this solution may not always lead to a faithful image but more towards a convenient image of the enterprise.

Thus, a distortion in financial quality information appears, creating uncertainties regarding the consistency and comparability of information designed for users, in which case we are dealing with intentional accounting, in other words, we are entering the sphere of creative accounting.

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2. Controversy regarding the definition of creative accounting

Trotman defines creative accounting as a communication technique aiming to improve information for the investors[†].

Following the same pattern, Colasse considers that the expression creative accounting designates “accounting informing practices on the border of legitimacy, practiced by certain enterprises that take advantage of standardization in order to embellish the financial statement image and economic and financial performances”[‡].

Stolowy reduces the significance of creative accounting by specifying that:
“Fraud has nothing creative about it, the practice of accounting options is old and does not constitute creative accounting, and the inherent subjectivity of evaluation is unavoidable and has always been here, because only a few financial mechanisms generate a true creative accounting. The distinct character of creative accounting, states the French author, is tied to accounting imagination placed at work to translate financial, economic and legal innovations which have not standardized accounting solutions and the montages that arise from this financial engineering are initiated according to their incidence over the balance sheet and company result”[§].

Barthes de Ruyter and Gelard place creative accounting in the imagination zone of modern financial engineering that creates new products and montages, in order to avoid accounting rules as a main or secondary purpose[**].

Naser gives a more complete definition[††] for creative accounting:

1) the process which manipulates accounting numbers and takes advantage of its flexibility, by choosing those measurement and disclosure practices that allow synthetic documents to be transformed from what they should be to what managers want;

2) the process that structures transactions in order to allow “producing” the wanted accounting result.

Although, the elements presented show the misunderstandings of creative accounting, they prove that most researchers accept the two aspects of it:

- Mainly, it implies the use of accounting experts’ imagination, to translate the legal, economic and financial novelties for which there are not standardized solutions, at the time of their appearance;
- Secondly, the montages resulting from this financial engineering are initiated based on their connection with the balance sheet and financial results of the enterprise.

Most of the literature explains the negative impact of creative accounting and its use with the sole purpose to mislead external users of synthetic documents. So, Griffiths states that “any firm truncates its benefits. Synthetic published documents are based on “fixed records” often butchered. The numbers presented to investors have been entirely manipulated in order to protect the guilty parties (managers)”[‡‡].

Still, authors like Malb and Giot draw attention to the fact that we don’t have to associate, automatically, creative accounting with something negative or perverted. Accounting novelty is necessary to keep up with economic, legal and social evolution. “*Creative accounting is originally virtuous: it gives means to keep up with increased development of markets and financial products. The problem subsides in the instinctive perversity of business men*”[§§].

Another reputed author gives several examples of accounting manipulation in order to hide the truth [***]:

a) Operating options connected to accounting policies permitted, basic and alternative treatments;

b) Preferential implementing of accounting evaluations:

- Assets devaluation test;
- re-evaluating fixed assets;
- changing ways to evaluate inventory;
- Partial evaluation of intangible assets and financial titles;

[†] M. Trotman (1993) Comptabilite britannique, mod d'emploi, Economica, Paris

[‡] B.Raybaud-Turrillo si R. Teller (1996), Comptabilite creative, Encyclope'die de gestion, Economica, Paris

[§] H. Stolowy (1994), Existe-t-il vraiment une comptabilite” creative?, Revue de droit comptable

[**] Citaţi de N. Feleagă

[††] K. Naser (1993), Creative financial accounting: its nature and use, Prentice Hall

[‡‡] I. Griffiths (1995), New creative accounting: how to make your profits what you want to be, Londra, City Editeur

[§§] J.L. Malb, H. Giot (1995), L'e'lasticite' du resultat selon Ies dimensions temps et espace, Congresul AFC

[***] Mihai Ristea (2004), Romanian Accounting Congress Ed. CECCAR, Bucharest

- changing the amortization rate;
- Policies flexibility regarding risks and expanses provisions;
- Domestic prices of assets disposal and the disposal of assets between branches of the same group;

c) Account manipulation by structuring and delaying real transactions;
d) Increasing the difference between the accounting entries value and purchase price by under evaluating the purchased asset and blaming the difference on reserves;
e) lease-back operations that allow selling an asset followed by renting it from the buying company. The effect subsides in improving treasury, decreasing the debt rate and increasing the benefits;
f) Alleviating loss claims by subscribing an insurance, which improves the result with the difference between devaluation loss value and the insurance premium paid;
g) Issuing hybrid securities that allow firms to change some debts into equity capital.

We notice that all methods used by creative accounting, as well as by accounting engineering, are highly differentiated and multiple from the point of view of components. In essence, creative accounting implies that the enterprise takes advantage from the normative and flexible existent breeches in order to distort published information.

Although there is a clear difference between creative accounting and breaking the law on purpose/ fraud, both are a part of financial difficulties and have the intent to deceive.

Some authors define accounting engineering as: “the process that manipulates accounting numbers, because of rule breeching, and taking advantage of flexibility chooses those information and measurement practices that allow transforming synthetic documents from what they are into what managers want” or “ the process that structures transactions so that allows “producing” the wanted accounting result”[†††].

Analyzing the two accounting systems (European continental and Anglo-Saxon) we might say that the inflexibility and prescriptive approach of the European continental system makes easier to reduce the abusive choice of accounting policies and manipulation of accounting estimates, while the Anglo- Saxon system leads to the use of revaluation and the prevalence of substance over form.

Both models give support to control creative accounting, as we can see from the following table:

Table 1. Opportunities for creative accounting

Opportunities for creative accounting	**Solution**	**Applied system**
Choosing accounting method	Reducing choice possibility	European continental
Estimating and forecast	Reducing estimation purpose	European continental
Closing artificial transactions	Prevalence of substance over form	Anglo-Saxon
Real transaction moment	Imposing re-evaluation	Anglo-Saxon

3. Classifying creative accounting practices

Using creative accounting practices, companies can change their image regarding obtained performance.

Presenting financial statements, as a result of approximate quantification, , for example: doubtful clients, correct value of assets and financial debts, life duration of assets, moral usage of inventory, can be made by influencing results or information provided by financial reports.

Market addressed information is simplified by presenting financial-economic indicators. Choosing one or more indicators is not neutral and the information provided is subjective. Knowing indicators that provide market judgment, firms are tempted to act upon numbers, thus establishing a direct causality between account complexity and manipulation: account complexity demands simplification that operates with easily manipulating indicators.

[†††] Naser C. (1993), Creative financial accounting: its nature and use, Prentice Hall, quotation by Feleagă N., Malciu L. (2002), Policies and accounting options, Fair Accounting versus Bad Accounting, Ed. Economics, Bucharest

Table 2. Practices that have an impact on enterprise results

Identified elements	Action mechanism	Performance impact	Boundaries	Process nature
Development and research expenses	Research- development expanses capitalization	Increasing results in capitalization year Decreasing in the transfer year and the years following The impact of choosing a date to start amortization	Fulfilling the conditions stipulated by normative regulations Evaluation difficulties of research costs	Opţion Subjectivity in evaluation
Assets	Lease-back contract	Appearance of a plus value from lease-back Recording leases during the time after asset acquisition	Artificial increase of result thanks to a commitment to pay leases for a certain period of time The risk of distributing fictitious dividends	Financial mechanism
Amortization	At the time of establishing the amortization plan there are many options and possibilities: - usage duration - estimating the residual value	Changing the recorded depreciation rate and of depreciation expanses	Need for an amortization plan Permanent methods	Personal appreciation Option
Inventory	Financial expanses incorporation into inventory production costs	Increasing the result during the year the expenses are incorporated Decreasing in the year of inventory annulment	Difficulty in defining borrowed assets and production financing Accounting has to present the expense value and explanation	Option
Adjusting devaluating and participation bonds	Under evaluating or over evaluating for impaired participation bonds	Increase(or decrease) of result in the recording year Reverse effect in the resumption year	Precautionary principle	Subjectivity in evaluation
Adjusting devaluating and current assets	Under evaluating or over evaluating adjustments for impairment of debts Under evaluating or over evaluating adjustments for impairment of inventory	Increase(or decrease) of result in the recording year	Precautionary principle	Subjectivity in evaluation
Risks and provision expanses	The existence of problems: - restructuring date decision; - level of precision regarding evaluation; -taking into consideration plus values of provision(although it is forbidden)	Impact on the result according to provision level Reverse effect in the resumption year	Precautionary principle	Option Subjectivity in evaluation
Long term contracts	The existence of many recording methods for these contracts: ascension percentage method, finishing work method	Impact on turnover according to the used method Different recognition of contract income	Precautionary principle	Option Subjectivity in evaluation

Source: Own processing and centralization

Some processes reveal creative accounting through some methods grouped as follows:
- Processes that have as outcome result modelling and managing decisions;
- Processes and techniques that have an effect on improving information from the balance sheet;
- Processes that have an impact on the income account presentation;

We should bear in mind that these processes have a certain "dose" of subjective accounting creativity, even though they change the account appearance, they still are the result of an option when chosen from a lot of methods; so we have to say they are in the accounting regulations area.

What if we ask what leads to these sorts of mechanisms? Before we answer we have to consider certain factors that generate the need for creative accounting, like:
- The need for financing: not enough assets, the need to follow certain indicators established by financial institutions or business partners (debt rate, action result);
- intensity of competition in crisis;

- Certain circumstantial factors
- Deterioration of results and financial statements;
- enhanced pressure on enterprises from investors and analysts, to communicate "make-up" results;
-the desire to ensure a stable quotation of shares when launching a private company;
-not enough accounting regulations, meaning liberty of decisions and space left by each regulatory organism.

The factors listed above create different interests on financial markets, where investors are aware that accounting "options" have always existed. Financial statements provide information that leaves room for interpretation, thus eliminating as much as possible the effects of creativity. If the purpose of accounting is to alleviate accounts (or at least the enterprise image), taking advantage of weaknesses and deficits of the system, we believe that this principle of option is well known by accountants for a very long time.

On the other hand fraud has nothing creative about it: it is illegal. Illegal "processes" don't even deserve to be mentioned, because these mechanisms have also, nothing creative about them.

Selecting and applying accounting policies falls into accounting standards and regulations sphere of flexibility, when creative accounting is concerned.

The manner in which accounting policies are applied is based on professional judgement.

In many cases this judgement leads to harming results and the reported financial position; but this is about aggressive accounting policies being applied and not fraudulent reporting.

At a certain point, accounting practices overstep accounting regulations boundaries, and so the financial statements do not present a faithful image of the results and financial position.

In order to decide if a financial report is fraudulent we have to prove the intent. What starts as an aggressive accounting policy application may lead later to a fraudulent financial report if it is done on a long period of time and has as purpose large sums.

Still, to prove the point when creative accounting becomes fraudulent is not always easy. *Proving this point is more about art than science*[‡‡‡].

Conclusions:

From our point of view, creative accounting is a useful instrument for managers, to promote and sustain company image, and to select information so that the data offered should maintain the interest that they have in mind.

Even though using creative accounting it's not illegal, it indicates the fact that the managers under financial pressure look for solutions without thinking of ethical issue at hand. In other words, ***a half truth and lying could be likely considered as fraud.***

The presence of options based on freedom of choice and appreciation enables management enterprise, according to its interests, to reverse reasons or translate legal, economic and financial innovations for problems that cannot be yet solved by regulations, which leads to creative accounting and subjectivism resulting in the shaping of results and financial statement contents.

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