Scientific Papers (www.scientificpapers.org)
Journal of Knowledge Management, Economics and Information Technology

Vol. III, Issue 6
December 2013

Detecting Creative Accounting Practices and their Impact on the Quality of Information Presented in Financial Statements

Authors: **Laura – Maria Popescu,** The Bucharest University of Economic Studies, Romania, laura.popescu09@yahoo.com, **Ileana Ashrafzadeh - Nișulescu,** The Bucharest University of Economic Studies, Romania, nisulescu_ileana@yahoo.com

This paper aims at presenting some methods of motivating, identifying and decreasing manipulation mechanisms in financial accounting data. Based on a research undertaken with Romanian companies, there has been produced a range of defining elements concerning the approach on creativity in accounting. Initially, we focused on the way business individuals perceive manipulation in accounting, the level of risk taking and the desire to identify such risks. According to our study undertaken, there is a high percentage likely to reveal the need of identifying creative practices in accounting and for becoming acquainted with the methods of achieving they should be structured according to the underlying interests and benefits.

Subsequently, relying on the data gathered there has been produced a series of strategies for limiting the financial accounting misleading data, considering all those involved in the economic activity. The conclusions largely confirm the initial hypotheses, an aspect otherwise revealing the need for security in accounting in the future, for generating trust through an accurate image instead of substantial increases, reinforcing thus the idea according to which a transparent company is a safe one, where anticipations are likely to become reality.

Keywords: *creative accounting; manipulation; regulations; detection; prevention; accounting practices.*

Introduction

The article discusses a well-known, extremely important issue of finding the most appropriate policies and strategies for preventing and detecting creative accounting. Therefore, the paper brings to attention a contemporary issue, which is also a necessary requirement in any economy, more so in a transition economy, threatened by economic and political crises. The theme is a step towards research and supply of solutions for a series of issues that the international accounting system is confronted with regarding the use of creative accounting in the current context.

The purpose of the paper is to present and analyze various conceptual and methodological fiscal, legal and accounting issues in a national and international context and to highlight some policies and strategies for preventing and detecting accounting creativity at international level.

The critical analysis of the current state of international regulations and the scientific literature for preventing and detecting creative accounting, the research theme may have a significant contribution in the development of knowledge in this field. Therefore, the absence of studies that examine the policies and strategies of preventing and fighting it in the European context, the relationship between national and international institutions, the performances of control and investigation systems in this field, the investigation and research methods and techniques, the current deficiencies of specialized research regarding the most important concepts used in this field, the insufficient knowledge of community regulations in the field and the optimal methods for taking it over in the internal law, as well as the disregard for investigative, regulatory, doctrinarian and jurisprudence experience by some member states of the European Union, are issues that need to be highlighted.

Due to its systematic, homogenous character and the diversity of information it provides, accounting seems the main supplier of information required for the decisional process. Its objective is to present information on the financial state, performance and changes of the financial position of an economic entity. However, this information is useful for the company's partners in the decision-making process only if this information fulfils certain characteristics regarding the quality of financial statements.

According to the Framework for the preparation and presentation of financial statements of the IASB, the analysis of the qualitative characteristics of accounting information is carried out around four vectors: understandability, relevance, reliability and comparability. These characteristics considered principal are supported by several related attributes: the relative importance, the accurate image, the priority of economic content over the judicial nature, neutrality, prudence and sufficiency (completeness). In the convergence process initiated by IASB and FASB, it was developed the project of a common conceptual document, entitled:"Conceptual framework for financial reporting", valid from January 1, 2011. In chapter 3 of these regulations, entitled „Qualitative characteristics of useful financial information", and the qualitative characteristics were divided into two categories: fundamental characteristics (relevance and faithful representation) and enhancing characteristics (comparability, verifiability, timeliness, understandability). Relevant information, which when is used can make the difference between the decisions of the users must have predictive value and/or confirmatory value. Moreover, information is material if its omission might influence the decisions that users take based on the financial information about a specific entity.

Research methodology

This study identifies and explains the most common accounting practice situations that generate an artificial growth of the accounting result and that lie at the threshold between creative accounting and accounting fraud. Some of these situations have also been promoted by large multinational companies which, for some of them, have led to bankruptcy. What were the consequences of using creative accounting by companies? Can these manipulations be identified? If yes, what are the main elements that lead to the elements that have undergone changes? To answer these questions, a regulatory study was conducted through the study of specialized literature.
Starting from the above-mentioned data, we initiated a market research based on survey, for finding out the opinion of individuals directly involved

in the management of financial accounting activity in companies. 200 questionnaires were given to be filled by employees of companies from 13 fields of activity, the results being processed with the SPSS program. Of these, 194 were answered, more exactly 23 partially and 171 completely, eventually becoming the centre of our research. In this way, we can highlight the similarities and differences between the perception of entrepreneurs and accountants concerning then on-standard practices and how they see the limits of accounting and the way their use influences the activity of the business. Also, the study results can shape the way of regarding the possibilities of detection and mitigation of accounting misleading data tools in a company's activity.

The research method used is based on information from secondary sources, namely documentation. We have chosen this method since it provides certain advantages in the research process: it is efficient in obtaining information, it allows the confrontation of the information it provides thus enhancing the level of reliability, requires a smaller information collection effort, the information obtained is more objective and, in certain cases, unique, providing information that is not available in other situations. The main secondary sources used were external sources such as official documents, magazines and specialized publications, statistic counts, the media, the internet, the documents of various companies analyzed and specialized literature.

The research instrument used in the study was the identification and the actual analysis of the data obtained after documenting and grouping them according to their importance and their relevance for the theme of the project.

The effects of using creative accounting techniques on the information provided by financial statements

Various effects that the use of creative accounting techniques may have on the presentation of information from annual statements are identified in the specialized literature, for example:

- The change of the value and structure of costs. The accounting regulations allow a certain margin of manoeuvre in quantifying the costs of the financial year. For example, for certain assets, only the maximum number of years in which they must be depreciated is indicated. A higher or smaller depreciation term affects the size of the result. Similarly, the provisions and the possibility to activate certain costs may be analyzed;

- The change of the value and structure of revenues. In certain situations, the recognition of revenues can be intensified or slowed down by applying the principle of prudence or the principle of connecting costs with revenues;
- Change of the value of assets. The existence of a flexibility regarding the calculation of depreciation and provisions creates the possibility of increasing or reducing the net value of assets. Moreover, stocks can be assessed by various methods and, consequently, their value may be different, which has a corresponding impact on the profit and loss statement. Such changes also alter the size of current and non-current assets, for example the indicators calculated on the basis of these assets;
- The change of the value and structure of internal capital. The change of revenues and expenses has an impact on the size of the result and, consequently, on the size of reserves. Therefore, this modifies the value of internal capital and of all shares calculated on the basis of this value;
- The change of the value of liabilities. In some countries, the accounting regulations allow the regularization of certain liabilities, such as retirement liabilities, for a period of time. Consequently, an enterprise aiming to enhance its result will allocate the liability for the maximum period permitted;
- The reclassification of assets or liabilities. Sometimes, there may be doubts regarding the category in which one item falls. This applies to securities that, depending on the intention of the enterprise, must be registered in current assets or in non-current assets, which affects the shares calculated for their benefit;
- The manipulation of information presented in the annex. There are parts of the annex that may include more or less information. The absence of relevant information may affect the decisions of external users.

Table 1: Detecting creative accounting techniques according to their impact

Crt. no.	Creative accounting practices	Impact on financial statements	Method of detection
1.	Increasing or reducing expenses with provisions and adjustments for depreciation	Reducing or increasing profit, internal capital, assets and liabilities	A,B,C
2.	Changing various elements of the depreciation policy such as the method, the duration or residual value	Reducing or increasing profit, internal capital and assets	A,B,C
3.	Including or not certain expenses in the asset production or purchase cost	Reducing or increasing profit, internal capital and assets	A,B,C,D
4.	Selecting fixed assets that will be included in the re-evaluation process	Reducing or increasing profit, internal capital and assets	A,B,C,D,E
5.	Taking into account the research-development costs, after the commissioning of assets or costs of debts, as expenses for the period or their capitalization	Reducing or increasing profit, internal capital and assets	A,B,C
6.	Accounting expenses on the basis of the retained earnings instead of including them in the profit and loss statement	Increasing profit	C,D,G
7.	Extra-balance financing on account of branches not included in the consolidation perimeter	Reducing liabilities	D,G
8.	Changes in the stock valuation methods	Reducing or increasing profit, internal capital	A,B,C,D

		and assets	
9	Accounting transactions by making future optimistic or pessimistic estimates	Increasing or reducing profit, internal capital of other assets or liabilities	A,B,C,D
10	Creating extraordinary results (sales of fixed assets, costs or revenues from previous years)	Increasing or reducing profit, internal capital of other assets or liabilities	E
11	Categorizing extraordinary results as ordinary and vice versa	Increasing or reducing profit, internal capital of other assets or liabilities	A,B,D,E
12	Anticipating the recognition of revenues or the postponing the identification of expenses	Increasing profit and internal capital	A,B,D,F
13	Postponing the recognition of revenues or anticipating the identification of expenses	Reducing profit and internal capital	A,B,D,F
14	Fictive sales	Increasing profit, internal capital and assets	B,C,D,F,G
15	Compensating assets with liabilities or expenses with revenues	Increasing or reducing profit, internal capital of other expenses and revenues	C,D
16	Assessing transactions with entities from the group at different prices than market prices or price falsification	Increasing or reducing the profit, internal capitals of other assets and liabilities	B,C,D,F,G
17	Appropriation of the commercial fund over the reserves or capitalization and depreciation during the period of utility	Increasing or reducing profit, internal capital of other assets and liabilities	A,B,C,D,F,G,H

Vol. III, Issue 6
December 2013

18	Changes of the holdings classification policy	Reclassifying assets and liabilities	A,B,C,E
19	Temporary assignment of holdings at a very high market value compared to their purchase and immediate redemption price	Increasing profit, internal capital and assets	C,D,E
20	"Mezzanine" financings (issue of bonds convertible in shares, bonds with share subscription warrants etc.) which cannot be included with certainty or internal capital, or financial liabilities	Reducing liabilities and increasing internal capital	B,C,D,E
21	Production of fixed assets	Increasing profit, internal capital and assets	D
22	Lease-back operations, sales of assets and immediate takeover in the location ,	Increasing profit, internal capital and reducing assets	C,D,E,G

Source: Created by the author

Methods of detection:

A. Comparisons of accounting policies used in the current financial year compared to previous financial years
B. Comparisons with accounting policies and methods used by competitors
C. Analyzing the existence of opinions with reserves in auditors' reports
D. Examining accounting registers
E. Analysis of the extraordinary results and previous extraordinary results
F. Analysis of the evolution of the period of rotation of client receivables, of stocks and of providers
G. Analysis of transactions with the enterprises from the group
H. Analysis of movements in reserve accounts

For detecting the manipulation of financial-accounting information, it is important to review the reasons behind this manipulation. Therefore, it is very important to motivate the use of financial-accounting maneuvers. Most of the times, practices of over-valuation or under-valuation of balance items and the profit and loss statement are used.

All investors should be able to answer two questions before committing to invest, namely if the company makes money and how this money is accounted. For this purpose, a table that structures various manipulating actions depending on the interests pursued and, therefore, signaling the elements that could attract attention on them, is presented below.

Table 2: Elements regarding the use of creativity in accounting

Crt. No.	Elements	Aspects to be pursued
1.	Strong personality of the management	Charismatic persons that are capable to manipulate
2.	Management motivation	Personal benefits, scale of low results, non-fulfilment of objectives
3.	Failure of internal control	Non-involvement of the surveillance council, independent of managers
4.	Failure of external control	Negligence or complicity of auditors, Failure to detect and exclude some irregularities that cannot be proven

Sursa: Created by the author

Theoretical model for reducing the use of creative accounting

The measures for limiting the use of financial engineering should derive first of all from the will of those who are misled by their use, but also from the desire to make the business safer, which is why the main initiators could be the legal, control and regulatory bodies and companies. The biggest struggle against denaturation of accounting information should be initiated by the company, because when its reality is affected, the company’s safety drops. Measures must be adopted at the level of the company depending on three important criteria:

The administrative system by implementing a notification system at the level of employees regarding the risks they are exposed to, encouraging the application of manipulation practices, the existence of a mechanism of redemption and protection of vigilant employees that identifies and signals deviations and by communicating the firm position against these practices inside the company, aimed primarily at persons in management positions.

The informational system through the transparency of information inside and outside the company, for users, creating a safe information system, where changes are made in a controlled manner and that allow the identification of some transitions that do not observe the imposed limits.

The control system through the evaluation of existing and future vulnerabilities of these practices, creating a system that avoids the accumulation of functions at the level of employees, the development of truly independent control and internal audit departments and through the implementation of a business monitoring system for certain periods of time.

As regards the external measures of the company, auditors should intensify their efforts to identify the potential manipulations of information supplied by financial statements. For this purpose, the audit function should include an assessment of the company's internal control system to prevent cases of creative accounting.

The orientation of external users, in particular investors, to cash flow information might discourage managers to use techniques of manipulation of accounting information. Accounting creativity can arrange revenues and expenses to present a more or less favourable situation, but cannot generate cash. A profitable business can be attractive, but if it presupposes a negative cash-flow from operating activities, it should attract attention and demand prudence from users.

General conclusions on preventing and fighting creative accounting

The causal chain that allows the development of the creative accounting system can be marked by the following nodal points: social organization - > state - > law- > creative accounting.

Complex measures must be taken to limit the option causes in favour of creative accounting, measures that focus on the framework of organization and management of the company in its entirety. At the level of the company, these measures must by perceived, in terms of taxation, as a reduction of fiscal pressure.

The insufficiency of accounting regulations, their heterogeneity and the on-going process of harmonization that, in the end, translate into a freedom of decision permitted by every regulatory body, are a series of factors that encourage the proliferation of accounting creativity.

Although there is a clear difference between creative accounting and the deliberate breach of the law (fraud), both phenomena appear in the context of financial difficulties of enterprises and are driven by the intention to deceive. Therefore, although the use of creative accounting is not always illegal, it shows that managers, under financial pressure, look for solutions without taking into account the observance of ethical standards. In other words, a half-truth and a lie are considered susceptible to possible frauds.

Table 3: The potential of using creative accounting

Consolidated by		**Reduced by**	
Reasons: - personal; - market-related.	**Opportunities of the economic environment:** - weak or non-existing laws and regulations; - low surveillance; - inappropriate compensation and no stimulation.	**Constraints of the economic environment:** - inappropriate compensation and stimulation of employees; - more appropriate regulations and the existence of a governing code; - consolidation of surveillance.	**Ethics and implementation of rules:** - more drastic sanctions; - presentation and observance of the code of ethics.

Source: created by the author

Creative accounting practices will disappear only with the disappearance of their underlying causes, therefore the desire of accounting regulators to limit creative accounting must take into account the circumstances that allow its manifestation. Yet experience shows that every time a new regulation is issued, entities find a way to minimize its impact.

Therefore, no matter how many rules the profession are implemented, there will always be persons who will find a way to "beat" the system. Thus, the mission of regulators and accounting professionals is not simple: imagination must be fought with imagination.

References

[1] Atik, A.,(2009), *Detecting income-smoothing behaviors of Turkish listed companies through empirical tests using discretionary accounting changes*. Critical Perspectives on Accounting, Volume 20, Issue 5, pp. 591-613 available on-line at: http://www.sciencedirect.com;

[2] Adrian Grosanu, Rachisan Paula Ramona and Berinde Sorin Romulus, (2011), *Study regarding the influence of Romanian accounting regulation on creative accounting techniques*; Annals of Faculty of Economics, 2011, vol. 1, issue 2, pages 523-528;

[3] Agostini, Marisa and Favero, Giovanni, *Accounting Fraud, Business Failure and Creative Auditing: A Micro-Analysis of the Strange Case of Sunbeam Corp*. (September 20, 2012). Department of Management, Università Ca' Foscari Venezia Working Paper No. 12/2012. Available at SSRN: http://ssrn.com/abstract=2149552;

[4] Baker, C.R., Hayes. R, (2004*), Reflecting form over substance: the case of Enron Corp*. Critical Perspectives on Accounting, Volume 15, Issues 6-7, pp. 767-785, available on-line at: http://www.sciencedirect.com;

[5] Benito, B., Montesinos, V., Bastida, F., (2008), *An example of creative accounting in public sector: The private financing of infrastructures in Spain*. Critical Perspectives on Accounting, Volume 19, Issue 7, Pages 963-986, available on-line at: http://www.sciencedirect.com;

[6] Dilip, K. S., (2006), *Creative Accounting in Bangladesh and Global*;

[7] Lambert, C., Sponem, S.,(2005), *Corporate governance and profit manipulation: a French field study. Critical Perspectives on Accounting*, Volume 16, pp.717-748;

[8] Feleaga Niculae, *Taming the accounting jungle,* Economica, Bucharest, 1996;

[9] Feleaga N, Malciu L., *Accounting policies and options*, Economica, 2002;

[10] Gearin M., Khandelwal S., *A true and fair view or mandatory standards?*, Australian Accountant, 1995, vol. 65, pp. 12-16;
[11] Goel A., Thakor A., *Why do firms smooth earnings?,* Journal of Business, 2003, vol. 76, no.1, pp. 151-192;
[12] Jones M., *Creative accounting, Fraud and International Accounting Scandals*, John Wiley and Sons Ltd, London, 2011;
[13] Loren Brandt, Johannes VAN BIESEBROECK, and Yifan ZHANG. *Creative Accounting or Creative Destruction? Firm-level Productivity Growth in Chinese Manufacturing*, Journal of Development Economic 97.2 (2012): 339-351 http://works.bepress.com/yfzhang/4;
[14] McBarnet D., Whelan C., *Creative Accounting and the Cross-Eyed* Javelin Thrower, John Wiley and Sons, Ltd., London, 1999, pp. 102;
[15] Naser, C. (1993). *Creative financial accounting: its nature and use*, Pretince Hall, quoted by Feleaga N., Malciu L., *Accounting policies and options, Fair Accounting versus Bad Accounting*, Economica, Bucharest, 2002;
[16] Nisulescu Ileana, *Enterprise financing and restructuring*, Infomedica Publishing House, Bucharest, 2000;
[17] Vinnari, E.M., Näsi, S., (2008), *Creative accrual accounting in the public sector: 'milking' water utilities to balance municipal budgets and accounts*, Financial Accountability & Management, Oxford, Vol. 24, Iss. 2; pg. 97, available on-line at: http://www.proquest.co.uk;
[18] Vladu Alina Beattrice and Adrian Grosanu, (2011), *Same insights regarding creative accounting in Romanian accounting environment-regulators, financial auditors and professional bodies opinion*, Annals of Faculty of Economics, 2011;
[19] Watts, R.L., Zimmerman J.L., (1990), *Positive accounting theory: A ten year perspective*, Accounting Review, 65, pp.131-156;
[20] Young M.R., *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide*, 2000, pp. 13.