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Improving the Numbers of Financial Statements

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Improving the numbers of financial statements can be achieved by several metods such as: recording the revenue too soon, recording bogus revenue, shifting the current expense to a futer or a earlier period, failing to record liabilities or shifting the cureent revenue to a later periods. As beeing science, technology or language of communication the accounting should reflect economic reality of transactions. Legal regulations, knowledge, creativity, management, and innovation spirit are all factors that are applied in practice and these factors contribute to economic reality through science of the reporting or 'financial position and performance tuning (creative accounting).

Keywords: *financial statements; fair value; cost of period; cost of acquired intangible asset; preferential dividends; return of goods; trade discounts*

JEL: *H32 – Firm; M41 – Accounting; M16 - International Business Administration*

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Introduction

Our study intends to highlight the mechanisms of the reasoning to interpret accounting and / or fiscal of financial transactions and economic events.

Accounting rules allow us to choose policies that accounting treatments to ensure the relevance and credibility of information and to present a true financial position of performance.

The evidences show us, however, there is the temptation of presenting of higher income, lower costs and higher profits.

Improving the numbers of Financial Statements

The current management agreement between the shareholders of ABC Entity (hypothetical entity) and executive management (CEO- Mr. X and CFO – Mr. Y) of the entity expires at 31 December "N". Under the provisions of this could be extended for the next three years ("N+1"- "N+3") if two conditions are fulfilled regarding the financial statements for "N":

- Condition 1: the value of Revenue to be at least CU 34.000.000 and
- Condition 2: the value of Profit before tax to be greater than CU 21.200.000.

The current executive management of the company believes that two mentioned above conditions are fulfilled. ABC shareholders hire TR&AL Audit Company (hypothetical entity) to check whether the two conditions are met. The trail balance at 31 December "N" presented by Mr. Y (CFO of ABC) to TR&AL Audit Company is presented below:

Table 1: Trial balance at 31 December "N" in CU'000

Account name	Balance/Amounts Debit	Balance/Amounts Credit
Land at valuation	10.500	0
Buildings at cost	15.750	0
Equipment at cost	3.500	0
Accumulated depreciation buildings	0	5.000
Accumulated depreciation equipment	0	1.075
Investment property	25.000	0
Computer software	810	
Equity investment at cost	1.250	0
Inventory	1.975	0
Accounts receivable	2.075	0
Accounts payables	0	3.510
Other receivables	160	0
Income tax expense	75	0
Tax liabilities	0	30
Debenture (redeemable "N+7")	0	2.500
Revenue	0	36.500
Cost of goods sold	12.482	0
Cost of rendered services	1.275	
Wages and salaries	225	0
Administrative expenses	180	0
Selling and distribution expenses	485	0
Operating expenses	350	0
Allowance for doubtful debts	0	175
Cash in hand and bank	1.490,51	0
Warranties	0	50
Interest expense	62,49	0
Interest income	0	200
Preference nonredeemable share capital	0	750
Ordinary share capital	0	25.000
Revaluation reserve	0	1.725
Retained earnings 01/01/ "N"	0	1,130
TOTAL	***77.645***	***77.645***

It can be note that is fulfilled the conditions, imposed by shareholders, according to the mounts from the above trial balance as follow:

- Condition 1: the value of Revenue is CU 36.500.000 and
- Condition 2: the value of Profit before tax is CU 21.640.510 (CU 36.700.000 total incomes less

CU 15.059.490 total expenses (except income tax expense)). TR&AL Audit has examined all significant transactions made by ABC during "N". Some of them must be reviewed and restated according to TR&AL Audit. These transactions are the following:

Transaction 1: Revaluation of investment property

State of facts: ABC Entity owns a building classified as investment property for which it is applied the fair value model. So, the value of investment property at 31 December "N-1" is CU 24.000.000. The investment property was revaluated at 31 December "N" by an independent assessor. The new fair value is CU 25.000.000 and the positive difference from revaluation is CU 1.000.000. The gain from revaluation has been recorded by the ABC and it was included in the amount of revenue from ordinary activities.

TR&AL's Opinion: If an entity chooses to apply the fair value model (IAS 40, Investment property, article 35) for the evaluation of its investment property than any gain or loss arising from changes in fair value shall be recognized in profit or loss of the period in which the change in fair value occurs. In other words „a gain or loss arise from changes in fair value of property investment must be included in Statement of Comprehensive Income" (Hennie van Greuning, 2009, page. 211).

Proposed adjustment: It can be noticed that the entity recognized the gain in profit or loss but classified incorrectly at position "Revenue". The gain must be included at position "other gains". So, the amount of Revenue must be reduced and simultaneously the amount of "other gains" must be increased by CU 1.000.000 (see below Note 1 for point III).

Transaction 2: Transfer of the risks and rewards in sale of goods transactions

State of facts: ABC Entity has recorded revenue from sale of goods and costs connected to this transaction:

- according to the commercial agreement between ABC Entity and Samurai Entity (hypothetical entity) from Japan, ABC Entity had to deliver the goods at the selling price of CU 400.000; delivery condition (INCOTERMS 2010) FOB – Tokyo destination seaport;
- carrying value of the goods sold is CU 300.000;
- goods were handed over to the carrier and the ship was loaded on 26 December "N"; and
- goods is expected to reach the destination at the end of March "N+1".

TR&AL's Opinion: Goods delivered – under FOB destination seaport - whether they are in transit should be included in ABC's inventory until the seller delivers them to the Japanese buyer at the destination agreed seaport. Only from this moment all significant risks and rewards arising from ownership of property were transferred to the buyer. ABC Entity owns all risks (e.g. risk of loss, damage) concerning the delivered goods until it delivers the goods to the buyer at the destination seaport. According to the paragraph 16 from IAS 18 „Revenue" it specifies that if an entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognized.

Proposed adjustment: ABC recognized incorrectly the proceeds from goods delivery as revenue and recorded incorrectly the carrying amounts of delivered goods as cost of sale. We propose reversal of the records (see below Note 2 for point III).

Transaction 3: Return of goods at the discretion of the buyer

State of facts: ABC recorded as sale of goods the following transaction:

- according to the commercial agreement between ABC Entity and DEF Entity (hypothetical entity), ABC Entity had to deliver the goods at the selling price of CU 1.000.000; delivery condition (INCOTERMS 2010) EXW – ABC warehouse address

- commercial mark – up for this transaction is 25%
- buyer has the right to return the goods at his sole discretion without any reason within 3 months.

TR&AL's Opinion: According to the paragraph 16 from IAS 18 „Revenue" it specifies that an entity retains the risks and rewards of ownership of delivered goods when the buyer has the right to rescind the purchase for a reason specified in the sales contract, or at the buyer's sole discretion without any reason, and the entity is uncertain about the probability of return.

Proposed adjustment: Due to the fact that this transaction is not, in fact, a sale than ABC has to cancel the recognized revenue and expenses with the cost of inventory. (see below Note 3 for point III).

Transaction 4: Recognition of fee income

State of facts: ABC signed two agreements at 01 January "N" with two hotels. According to the signed agreements ABC had to sell tourism programs provided by the hotels according to the following conditions:

- the prices for the tourism programs are established by the hotels
- the fee of ABC is 15% of the value of each sold tourism program
- the amounts collected by ABC on behalf of the hotels are paid- after ABC has retained the fee - within 5 days of collection day but no later than the end of month

ABC Entity sold during "N" tourism programs in the amount of CU 1.500.000. For each program sold the ABC Entity records at the moment of sale the entire program's amount as income (revenue). The amounts (collected amounts less retained fee) paid by ABC are recognized at the moment of payment as an expense (cost of rendered services).

TR&AL's Opinion: In our opinion, ABC hasn't altered the size of the operating profit but the value of revenue has been incorrectly increased at the level of tourism program's prices and the value of expenses has been incorrectly increased at the level of the amounts paid to the hotels. "IAS 18 stipulates that, when an entity is acting in the capacity of an agent, its gross inflows of cash or other economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. Since amounts collected on behalf of the principal are not revenue, the reporting entity's revenue should only be the amount of the commissions it receives. To report the gross amounts collected as revenue in such circumstances would exaggerate and greatly distort the scope or scale of the entity's actual operations" (Barry J. Epstein and Eva K. Jermakowicz, 2010, page 284).

Proposed adjustment: ABC Entity has to reduce the value of income in order to be presented only the amount of the fee earned by ABC from the hotels. Also ABC has to cancel the amounts included in the cost of rendered services. The additional (excess) amount which has been included by the ABC in revenue and also in cost of rendered services is CU 1.275.000 (Below Note 4 for point III).

Transaction 5: Depreciation of equity instruments

State of facts: According to ABC's accounting policy any change in the value of equity instruments is recognized through profit and loss. The market value of the equity instruments is CU 1.250.000 at 01 January "N" and it is presented in the above trial balance. The market value of the equity instruments at 31 December "N" is 10% lower than the value of the beginning of the year.

TR&AL's Opinion: We consider that ABC has not applied its own policies related with impairment of financial investments.

Proposed adjustment: ABC has to record a decrease of equity instruments 'value by recognizing an expense. The expense amount is CU 125.000. (See below Note 5 from point III).

Transaction 6: Trade discounts received for purchased goods

State of facts: ABC recorded at 16 December "N" a commercial discount granted by a supplier as a reduction of cost of goods sold. The value of the commercial discounts is CU 200.000. This commercial discount was granted for purchases of goods named “X” during “N”. At 31 December “N” ABC has 35% from the “N” purchases of “X” goods included in inventory.

The value of cost of goods sold has been incorrectly diminished with the entire value of the discounts granted by the supplier. The value of cost of goods should be reduced only by CU 130.000 [200.000*(100%-35%)].The difference of CU 70.000 should to reduce the value of inventory which has not been sold because „trade discounts and rebates are deducted when arriving at the cost of purchase of inventory”(Abbas Ali Mirza et al,2008, page 28).

Proposed adjustment: ABC must record an increase of cost of goods sold and – in the same time- a decrease of inventory’s value by CU 70.000. (See below Note 6 from point III).

Transaction 7: Cost of period versus capitalized costs of intangible asset

State of facts: During last quarter of “N” ABC entity purchased and implemented new computer software. ABC has signed a contract with an entity which is specialized in market research in order to identify the software producers. Entity must provide the ABC a research which set out the advantages and disadvantages of various software programs that could be purchased by ABC. The cost of the market research was CU 52.000.

Based on the research report ABC Entity decides to buy the software from BSW (hypothetical entity). The acquisition and implementation of the new software were done in two stages as follow:

- Stage 1 – BSW has carried a review and an update of IT (hardware and software) network of ABC in order to determine if existing hardware is adequate for new software; the cost of this operation was CU 77.000;
- Stage 2 – Effective implementation process, which was completed at 20 December “N”, had a price of CU 600.000;
- Stage 3 – Training period for the employees had CU 11.000 price.
- Also ABC has signed a contract with a legal adviser entity which perfected contract between ABC and BSW. Costs charged by legal adviser entity were CU 10.000. All mentioned above costs involved

in purchasing of the new software were CU 810.000 um and they we completely capitalized and recognized as intangible assets.

TR&AL's Opinion: ABC Entity should not capitalize the all costs as follow:

Cost description	Capitalization (Yes/No)	Cost value	Expenses of year	Amount capitalized
Market research	**NO**	52.000	52.000	-
IT network review and up date	YES	77.000	-	77.000
Effective implementation	YES	660.000	-	660.000
Training period	**NO**	11.000	11.000	-
Legal services	**NO**	10.000	10.000	-
Total costs		***810.000***	***73.000***	***737.000***

"Examples of costs that are not included in the production cost (Ristea M. et. al, 2009, page 150-151):

- selling expenses, administrative and general overhead, unless the expenditure can be directly attributed to preparing the asset for use;
- identified inefficiencies and initial operating losses incurred before the asset achieves planned performance;
- training of staff who is handle the asset"

Proposed adjustment: ABC must increase the costs of the period and – in the same time- to decrease the value of intangible asset by CU 73.000 (See below Note 7 from point III).

Transaction 8: Warranties granted to the customers

State of facts: ABC entity grants a 2 year warranty for products sold to its customers. CU 50.000 amount for warranties, presented in the above trial balance, was established at the end of the previous year. After the technical department discussion the proper amount of provision for warranties is CU 59.000 at 31 December "N".

ABC did not increase the value of warranties. The balance for warranties at 31 December "N" has to be CU 59.000.

Proposed adjustment: ABC must increase the costs of the period by CU 9.000. (See below Note 8 from point III).

Transaction 9: Debenture interest

State of facts: Debenture was issued at 01 July "N" (interest rate is 10%). The interest is quarterly paid as follow:

Interest period	Payment date
July-September "N"	05 October "N"
October-December "N"	05 January "N+1"
January –March "N+1"	05 April "N+1"
April –June "N+1"	05 July "N+1"

Interest recorded for period July _September "N" was paid at 05 October "N".

TR&AL's Opinion: The interest expense for October – December "N" period was not recorded by the ABC. ABC must increase the interest costs. Total interest costs for "N" is CU 124.998 (6 months x CU 20.833 /month)

Proposed adjustment: Interest costs already recorded by the entity are CU 62.490. Interest costs have to be increased by CU 62.508. (See below Note 9 from point III).

Transaction 10: Trade discount granted by ABC to one of its customer

State of facts: ABC Entity has to grant- under the mutual agreement - to one of its customer a "N" year-end trade discount of CU 230.000 for the purchasers made by the customer during "N". ABC did not issue a credit note for the mentioned amount but instead the customer issued the invoice for CU 230.000. ABC recorded this invoice as a selling and distribution expense.

TR&AL's Opinion: In fact this trade discount has to diminish the value of revenue for the year and it should not increase the value of selling and distribution expense. Simple reason that ABC didn't issue the invoice (credit note) for the granted trade discount and – instead- the invoice was issued by the customer (debit note) should not change the nature of the economic transaction.

Proposed adjustment: ABC has to decrease the value of selling and distribution expense and to decrease simultaneously the revenue with the same value of trade discount (CU 230.000) (See below Note 10 from point III).

Transaction 11: Preference nonredeemable shares

State of facts: Dividend for preference nonredeemable shares is 5% per year.

TR&AL's Opinion: Preferential dividends for "N" have not been recorded by ABC. ABC has to record CU 37.500 preferential dividends as liability at 31 December "N".

Proposed adjustment: See below Note 11 from point III.

Transaction 12: Tax income expense and other costs

State of facts: Tax liabilities must be increased by CU 12.500. Wages and salaries have to be divided as follow: 80% as cost of sales and 20% as administrative expense.

Proposed adjustment: ABC has to increase tax income expense by CU 12.500 (See below Note 12 from point III).

Summary of proposed accounting adjustments

Proposed Adjustments Register			
Transaction	***Description***	***DEBIT***	***CREDIT***
Note 1	Investment property	-1.000.000	
	Revenue		-1.000.000
	Investment property	1.000.000	
	Gain on investment		1.000.000
Note 2	Accounts receivables	-400.000	
	Revenue		-400.000
	Cost of goods sold	-300.000	

	Inventory		-300.000
Note 3	Accounts receivables	-1.000.000	
	Revenue		-1.000.000
	Cost of goods sold	-800.000	
	Inventory		-800.000
Note 4	Cost of sales- services	-1.275.000	
	Revenue		-1.275.000
Note 5	Loss on holding equity instruments	125.000	
	Equity investment		125.000
Note 6	Cost of goods sold	70.000	
	Accounts payables		70.000
	Inventory	-70.000	
	Accounts payables		-70.000
Note 7	Selling and distribution expenses	73.000	
	Computer software		73.000
Note 8	Operating expense (Cost of sale)	9.000	
	Warranties		9.000
Note 9	Interest expense	62.508	
	Accrued interest		62.508
Note 10	Revenue	230.000	
	Selling and distribution expenses		230.000
Note 11	Retained earnings	37.500	
	Preference dividend payable		37.500
Note 12	Income tax	12.500	
	Tax liabilities		12.500
	TOTAL	**-3.225.492**	**-3.225.492**

Adjusted Trial Balance at 31 December "N" - in CU '000 –

Account name	***Note***	***Debit***	***Credit***	Debit Adjustment	Credit Adjustment	***Debit***	***Credit***
Land at valuation		10.500,00	0,00	0,00	0,00	10500	0
Buildings at cost		15.750,00	0,00	0,00	0,00	15750	0
Equipment at cost		3.500,00	0,00	0,00	0,00	3500	0
Accumulated depreciation for buildings		0,00	5.000,00	0,00	0,00	0	5000
Accumulated depreciation for equipment		0,00	1.075,00	0,00	0,00	0	1075
Investment property –valuation at	***1***	25.000,00	0,00	-1.000,00	0,00		
	1			1.000,00	0,00	25.000,00	
Computer software	***7***	810,00	0,00	0,00	73,00	737	0
Equity investment at cost	***5***	1.250,00	0,00	0,00	125,00	1125	0
Inventory at	***2***	1.975,00	0,00	0,00	-300,00		
	3			0,00	-800,00		
	6			-70,00	0,00	3.005,00	
Accounts receivable	***2***	2.075,00	0,00	-400,00	0,00		
	3			-1.000,00	0,00	675,00	
Accounts payables	***6***	0,00	3.510,00	0,00	70,00		
	6			0,00	-70,00		3.510,00
Other receivables		160,00	0,00	0,00	0,00	160	0
Tax liabilities	***12***	0,00	30,00	0,00	12,50	0	42,5
Debenture (redeemable 2020)		0,00	2.500,00	0,00	0,00	0	2500
Allowance for doubtful debts		0,00	175,00	0,00	0,00	0	175
Cash in hand and bank		1.490,51	0,00	0,00	0,00	1490,51	0
Warranties	***8***	0,00	50,00	0,00	9,00	0	59
Preference share capital		0,00	750,00	0,00	0,00	0	750
Ordinary share capital		0,00	25.000,00	0,00	0,00	0	25000
Revaluation reserve		0,00	1.725,00	0,00	0,00	0	1725
Retained earnings	***11***	0,00	1.130,00	37,50	0,00	0	1092,5

Accrued interest	9			0,00	62,51	0	62,508
Preference dividend payable	11			0,00	37,50	0	37,5
Revenue	1	0,00	36.500 ,00	0,00	-1.000,00		32.595 ,00
	2			0,00	-400,00		
	3			0,00	-1.000,00		
	4			0,00	-1.275,00		
	10			230,00	0,00		
COST OF GOODS SOLD	2	12.482 ,00	0,00	-300,00	0,00	11.461 ,00	
	3			-800,00	0,00		
	6			70,00	0,00		
	8			9,00	0,00		
Cost of sales- services	4	1.275, 00	0,00	-1.275,00	0,00	0	0
Wages and salaries		225,00	0,00	0,00	0,00	225	0
Administrative expenses		180,00	0,00	0,00	0,00	180	0
Selling and distribution expenses	7	485,00	0,00	73,00	0,00	328,00	
	10			0,00	230,00		
Operating expenses		350,00	0,00	0,00	0,00	350	0
Interest expense	9	62,49	0,00	62,51	0,00	125	0
Interest income		0,00	200,00	0,00	0,00	0	200
Income tax	12	75,00	0,00	12,50	0,00	87,5	0
Gain on investment	1			0,00	1.000,00	0	1000
Loss on holding equity instruments	5			125,000	0,00	125	
TOTAL		**77.645 ,00**	**77.645 ,00**	**-3.225,49**	**-3.225,49**	**74.824 ,01**	**74.824 ,01**

Statement of Comprehensive Income for the year ended 31 December "N"

Description	*Value*
Revenue	32.595
Cost of sale	-11.641
Gross profit	20.954
Operating expenses	-350
Distribution costs	-328
Administrative expenses	-225
Profit from operations	**20.051**
Finance costs	-125
Interest income	200
Gain on investment	1.000
Loss on holding equity instruments	-125
Profit before taxation	21.001
Income tax expense	-87,5
Profit for the year	20.913,50

Statement of Financial Position for the year ended 31 December "N"

ASSETS

Non-current assets

Property, plant and equipment		23.675,00	
Investment property		25.000,00	
Equity investment at cost		1.125,00	
Computer software		737,00	
			50.537,00

Current assets

Inventories		3.005,00	
Trade and other receivables		660,00	
Bank	1.490,51		

		5.155,51
Total assets		**55.692,51**
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital	25.000,00	
Preference share capital	750,00	
Revaluation surplus	1.725,00	
Retained earnings	1.092,50	
Profit for the year	20.913,50	
		49.481,00
Non-current liabilities		
Debenture	2.500	
		2500
Current liabilities		
Trade and other payables	3.572,51	
Preference dividend payable	37,5	
Warranty	59	
Tax liabilities	42,5	
		3.711,51
Total equity and liabilities		**55.692,51**

Conclusions

Based on above financial statements we check if the conditions mentioned into the management agreement are achieved:

Keys	Target amounts	Amounts recorded before adjustments	Amounts recorded after adjustments	Conditions achieved
A	**1**	**2**	**3**	**3 > 1**
Revenue	34.000.000	36.500.000	32.595.000	NO
Profit before tax	21.200.000	21.640.510	21.001.000	NO

If the recommended adjustments are recorded than the executive management (CEO- Mr. X and CFO – Mr. Y) of ABC Entity do not achieved the conditions. Globally, TR & AL found these differences:

	Items	Amounts recorded before adjustments	Amounts recorded after adjustments	Difference
A	B	1	2	3 = 2 - 1
1.	Revenue	36.500.000	32.595.000	- 3.905.000
2.	Other income	200.000	1.200.000	+1.000.000
3.	Total expense, without tax on income	15.059.490	12.793.998	- 2.265.492
4.	Profit before tax (4 = 1 + 2 - 3)	21.640.510	21.001.002	- 639.508

- revenue has been decreased by CU 3.905.000 (CU 32.595.000 less CU 36.500.000), because of:
    - decreasing the revenue by CU 1.000.000 after reclassification of current income from the revaluation;
    - decreasing the revenue by CU 400.000 regarding the goods delivered under FOB destination seaport;
    - decreasing the revenue by CU 1.000.000 because of return clause;
    - decreasing the revenue by CU 1.275.000 by limiting the revenue at the level of fee income earned by the entity from tourism packages sold;
    - decreasing the revenue by CU 230.000 as a result of trade discounts to customers;
- expenses has been decreased by CU 2.265.492, because of:
    - decreasing by CU 1.100.000 by cancelling cost generated by delivered goods under FOB condition and delivered goods with a return clause;
    - decreasing by CU 1.275.000 – the costs of tourism packages;
    - decreasing of selling and distribution costs by CU 230.000 as a result of reclassification of trade discounts;
    - increasing by CU 70.000 as a result of restating of trade discounts for the unsold goods at the end of the year;

- increasing by CU 73.000 as a result of reclassification of costs regarding the intangible assets (software);
- increasing of warranties by CU 9.000;
- increasing the expense by CU 125.000 due to the recognition of a decrease of market value of held equity instruments
- increasing by CU 62.508 regarding interest expense for debenture.

- profit before tax has been decreased by CU 639.508 (CU 21.001.002 less CU 21.640.510), because of:
    - changes in current revenue structure (- CU 3.905.000);
    - changes in other income (+ CU 1.000.000);
    - changes in expense structure (-CU 2.265.492).

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