

CREATIVE TECHNIQUES FOR MODELING PERFORMANCE REPORTED IN FINANCIAL STATEMENTS

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Abstract:

The profit and loss account summarizes the ensemble of operations that contributed to the formation of the result, profit or loss. The economic theory considers that the goal of any enterprise is to maximize profits. There are, however, enterprises that wish to obtain only a satisfactory profit. Accounting practices allow to enable enterprises to present, within certain limits, results compliant with their goals rather than with reality.

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Some of these practices, called accounting policies, result from choosing between different accounting methods and have the purposefulness of improving the current and the net result, or altering the outcome without affecting the net result.

Other practices, called management decisions, don't represent a simple game of accounting records, but operations which were actually performed by the organization and that have as a result the improvement of the current and net result.

One of the creative techniques of financial performance manipulation is related to the application of accounting policies. Accounting policies include accounting managers' options regarding accounting variables. In an extensive understanding, they refer to:

- choosing (or modifying) the assessment methods; choosing (or modifying) the presentation methods of the synthesis documents;
- establishing the amount and the aggregation degree of the information published in the synthesis documents, generally and in particular in the annex;
- establishing the information published in the annual report;
- setting the communication date of financial information;
- voluntary publication of certain optional synthesis documents (for example, the funding panel); choosing (or modifying) the auditor; alignment (partial or total) to the international accounting referential or to the internationally recognized accounting referential;
- abandonment of certain accounting principles.

The accounting policy objectives differ from one company to another. Thus, a company which appeals to public saving considers of great importance the financial consequences of the decisions taken (impact on dividend distribution, the stock market rate, the vulnerability to a public purchase offer, and impact on the relations with third parties), and a privileged small or medium enterprise, often, for tax optimization.

As a result, depending on the context, the accounting policies can have as an objective: reducing published losses, reduction of taxable benefits, increasing or decreasing the current result, increasing or decreasing the distributable benefits,

temporary smoothing of the accounting results in order to reduce the risk perceived by the financial environment, etc.

While in an optimization strategy, accounting policies aims at choosing the most appropriate accounting methods in a given regulatory framework, management decisions are necessary in a strategy of avoiding the entities' rules and boundaries (organizational or legal). Management decisions have as their main objective the presentation of different images of the result, though, in essence, they do not affect the situation of entity. The accounting result is therefore a very flexible concept. Its flexibility is related to the time and space dimensions.

Flexibility over time results from the present/future confusion and the latent reveal in applying the exercises specialization principles and connecting expenses with revenue, thus:

a) Connecting expenses of the exercise with future revenues

Production in progress, long-term contracts and capitalization expenses create difficulties in inventory assessment and bring into question the issue of future revenue streams and the recovery period of capitalized expenses. Therefore, the results of companies operating with these elements have a subjective character.

In the case of certain elements, such as the production in progress, due to the reduced time horizon and the compensation of results regarding different operations, subjectivity is not risky. However, in the case of others, risks are important. Thus, numerous groups are registering in their balance sheet items such as: market share, commercial networks, files etc. This practice affects the comparability of accounts because the created assets are registered in the balance sheet only for part of the cost. In addition, being subject of an annual assessment, the created assets represent a favorable ground for the manifestation of the managers' subjectivity. Subjectivity may even take acute forms if changes occur in the structure of the group.

For example, bakery company A (20% of the market of bakery products) acquires brand and commercial network from bakery company B (15% of the market of bakery products) and proceeds to the abolition of the trade mark B. The question is whether a possible further reduction of the total market share, say 28% shall be attributed to trade mark A or trade mark B?

b) Connecting future expenses with revenues of the exercise

The principle of prudence requires managers to identify the operative events for future expenses which originate in the present exercise and to establish provisions. However, established provisions may have different effects on the outcome. It is the case of restructuring provisions.

The economic foundation is simple: when a company decides to make a purchase, it has to consider also the necessary restructurings and reorganizations in order to optimize the ensemble resulting from the acquisition. The problem that arises is whether the restructuring provisions must affect the result, or the difference in purchase.

Big companies prefer the second solution: instead of displaying their restructuring expenses for a year or two, the counterpart provision will be depreciated in the rhythm of the difference in the acquisition or will never be depreciated, if the company was cautious and capitalized its intangible non-depreciating elements. The problem lies in the fact that these assets can become quickly fictitious without external users noticing this.

Also, the events after the fiscal year is closed sometimes can lead to the formation of provisions under imprecise conditions. Thus, the provisions for "redesigning the social pyramid" are usually based on technical grounds that are hardly verifiable by auditors and easily changeable in the subsequent financial years.

c) Integrating latent profits in the result of the exercise

The most well-known examples of achieving latent profits in order to bring the result of the exercise at the desired level are: sales followed by repurchases; sales of old fixed assets; lease-back operations.

d) Ignoring latent losses

Companies may be tempted to minimize latent losses by myopia (ignoring the possibility of losing a major customer) or by calculation (sales on credit without interest).

As regards to the elasticity in space, this results from "half true- half false" operations (indebtedness in fact, insurance claims, insurance against the risk of interest rates increase, etc.) and from the classification of operations (if a creditor is qualified as a shareholder, the financial expenses become dividends and they no longer reduced the result; is a third party really a third party or is actually part of the group?).

Therefore, it appears that the classical leveling techniques are completed, increasingly more, by a "real" management of the result. Although this management is based on the action on accounting principles, some authors consider however that there are no "incompatibilities of substance between fundamental accounting principles and creative accounting, if the latter is used with discernment in a" field of application clearly delimited and complying with the spirit in which this notion appeared".

The depreciation policy adopted by an organization affects the evolution of the result. The parameters which have this lasting influence are the depreciation period and depreciation method. Theoretically, according to the permanence methods principle, companies can influence the result through the depreciation policy only in the year in which an investment is made.

Another policy with impact on the result refers to provisioning. These provisions are intended to cover risks, expenses or losses whose object is determined with precision, but whose accomplishment and proportion are uncertain. Requiring estimations, provisions create conditions for leveling results. Thus, "inflating" provisions throughout the beneficiary years diminishes the result, and "deflating" provisions throughout the deficient years increases the result.

Companies that use credits with a variable rate interest are trying to insure themselves against the risk of interest rates increase, while retaining the right to benefit from any reduction of this rate. As a result, they are addressed to a bank, which, for premium insurance, guarantees that if the interest rate will exceed a certain level, it will pay the difference between the achieved level and the guaranteed level. This insurance operation is known as "CAP operation".

Normally, this CAP operation is used for insurance against unpredictable interest rate increase over a level considered very high. However, there are companies that use it to ensure against interest rate increases over a threshold which, having a reduced level, will certainly be exceeded. Although in this case the risk achievement being certain, the insurance premium is higher, the CAP operation allows the company to level the results: within the year of signing the CAP contract the expenses will be increased by the amount of the insurance premium, and in subsequent years revenue will be increased with the amounts received from the insurer, amounts representing the interest rate increase over the guaranteed level.

Another case concerns small and medium-sized enterprises which are characterized by a small number of employees. Most often the owner-manager is their only employee. In appearance, this situation seems to benefit the owner, because the lack of salary costs influences, meaning increase, the accounting result and therefore the size of dividends.

But the high taxation incites the managers to seek ways for assimilating a portion of the value added which is less expensive than the distribution of dividends.

Such a way is hiring within a company, in collaboration, of persons belonging to the owner's family.

However most of the techniques of performance embellishment are found at the level of large companies listed on the stock exchange.

The reasons listed by the directors of companies for manipulating accounts can be different:

- revenue leveling. In general, companies prefer to report a constant increasing trend of profits than to present volatile profits with a series of dramatic increases and decreases. This is achieved through the formation of large provisions in good years, so that this provision should be reduced, improving the reported profits, in the weaker years. Another trend that often occurs is called the "big bath" accounting, in which a company that registers a great loss is looking to maximize the loss reported in that year, so that the future years to look better.

- an option of leveling revenue is manipulating profits in order to meet forecasts. Fox (1997) shows how Microsoft accounting policies are thus established, in the accounting rules, that the reported results are connected to the forecasts of profits. When Microsoft sells software, a large part of the profit is deferred to future years in order to cover the costs with potential changes (upgrade) and later with the assistance given to clients. This accounting policy, perfect and very conservative, leads to an easy forecast of future revenues.

- directors of companies can apply the accounting policy to increase revenue in order to divert attention from the unwelcome news regarding the company.

- creative accounting may maintain or increase the price of shares both by reducing the apparent levels of debts (making the company look less risky), and by creating an appearance regarding the tendency of profits. This will help the company to attract capital through the issue of new shares, to offer its own shares in takeover bids and to resist the takeover by other companies.

- Directors can use creative accounting to delay the dissemination of information to the market, having the opportunity to benefit from the internal knowledge.

Another set of reasons for the application of creative accounting in embellishing performance occurs due to the fact that companies are subject to various forms of contractual rights, obligations and restrictions based on the amounts reported in the financial statements. Below are presented such examples.

At international level it is a common practice that financing agreements include restrictions on the amount that can be borrowed based on the size of equity.

When a company has loans located near this limit, appears the motivation to:

- choose the accounting methods which would lead to an increase of the reported profit;

- arrange financing in such a manner as to not be reflected as a debt in the balance sheet.

In some industrial sectors, such as electricity and telephony, utility companies fall under the authority of a governmental body that sets the maximum amounts that can be spent. If these companies report big profits, then the Government body will proceed with a price decrease. Therefore, these companies are interested in choosing the accounting methods which tend to reduce their reported profits.

In addition, the premium scheme for the director may be linked to the level of profits or the price of a company's shares. If it is linked to the price of a stock, then it is clear that the directors will be motivated to present financial statements that would impress the stock market. If the premiums (bonuses) are related to the level of the reported profit, then the scheme provides that the premium is a percentage of the profits above a minimum level and is payable up to a maximum level. Thereby:

- if the profit lies between the two limits, the directors will apply the accounting methods that lead the profit to the maximum limit;
- if the profit is below the minimum limit, the directors will apply the accounting methods that maximize the provision, in the coming years, in order that these provisions are reflected in the income and increase profit;
- if the profit is above the maximum limit, the directors will seek to reduce the profit to this limit, and in the following years the profits could be increased.

Conclusions

When a segment or a division of a business is subject to a profit-sharing arrangement, then it may affect the chosen accounting methods.

In developing countries, and not only, taxation is also a factor in creative accounting, in situations where the taxable profit is measured based of the accounting figures.

Changing the management of large companies entails motivation of the new managerial team to establish provisions which ensure that any loss appears as a responsibility of the previous management.

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