CREATIVE ACCOUNTING - THE RESULT OF PRESSURES FROM USERS

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Abstract:
In periods characterized by major difficulties, in economic terms, managers are most often tempted, we might say, to use, even manipulate accounting in order to improve the performance of the economic entity in a manner that would not properly reflect the whole picture of economic entity. It can be said that where the economic entity managers trying to use flexibility provided by the accounting to increase its assets or increase its profits, we can speak of creative accounting, while what goes beyond accounting flexibilities can be transformed into fraud.

Key words: *creative accounting, financial statements, fraud, manager, users*

JEL classification: *M41*

1. The concept of Creative Accounting

Creative accounting, accounting scandals and fraud date back to ancient Mesopotamia, to the collapse of the market in the years 1719-1720 due to the South Sea Company, to more recent accounting scandals, such as Parmalat and Enron. In times characterised by major economic difficulties, we could say that managers are most often tempted to use and even manipulate accounting in order to improve the performance of the economic entity in a way no longer accurately reflecting the overall picture of the economic entity. When an economic entity's managers are trying to use the flexibility offered by accounting to increase assets or even increase profits, we speak of creative accounting, while exceeding accounting flexibilities can turn into fraud. An economic entity's financial difficulties makes managers record fictitious transactions and use accounting techniques outside the legality allowed by accounting regulations.

Creative accounting often brings to mind a negative process performed with a negative effect on handling accounting data. However, if this creativity offered by the flexibility of accounting rules is used correctly and honestly, it can bring benefits for those who use it; however if it is used by someone with malicious intent, it can only cause damage.

How a transaction is reflected when there are more options in terms of this kind of reflection is done to obtain different results, depending on the option selected, making us say that the result is more a subjective than objective. The net profit of economic entities may be influenced by the professional chosen to measure various accounting operations. Of course, the choice of an option is made as permitted by existing accounting rules. The limits depend on the accounting policies applied by each economic entity. These accounting policies depend on the choices made by the economic entity in order to give some form or content to statements made naturally in compliance with existing accounting rules.

2. Motivation for Using Creative Accounting

Determining the reasons for which economic entities resort to creative accounting techniques is of great importance to follow the logic of the research. Thus, Amat, O., Blake, J., Dowds, J. list the reasons why economic entities try to use the creativity provided by accounting rules' flexibility (Amat, O.; Blake, J.; Dowds, J., 1999):

- "*income smoothing*". This method is used to try to mitigate variations of profit characterised by its increases and decreases, by providing an image showing a profit with a growing trend. This method assumes that during a year an economic entity records good results it should establish – actually unnecessary – provisions higher than the value of assets in order to use them to "smooth" profit during years when profit is declining;
- comply with the limits included in predictions;
- creative accounting may help to maintain or increase share price by artificially creating a positive profit trend, helping the economic entity gain capital from the issue of new shares and resist other economic entities' attempt to take over the entire economic entity.

Also, Sutton lists the reasons of managers who try to manipulate accounting figures (Sutton, 2004, p. 672):

- *to reduce taxes.* Taxes paid to state institutions are costs for the economic entity for which the latter tries to find ways to reduce them. State institutions offer grants and tax reductions, and economic entities try to take maximum advantage thereof;
- *to obtain capital at a cost as low as possible*. Economic entities can increase own capitals under favourable terms provided that they are perceived as having an as low as possible financial and operational risk, which makes economic entity managers try to reduce debt effects or mitigate changes in reported incomes.
- *to avoid breaching credit contracts*, by managing key figures, such as interest expenses, profit, total debt and equity;
- *to increase managers' wealth*, if there is a link between the profit obtained by the economic entity and how they are paid.

Shah & Butt, in 2011, consider that managers are motivated to "arrange" the information contained in financial statements due to the following (Shah & Butt, 2011, p. 98):

- to achieve in-house objectives. Managers try to achieve the objectives of profitability, sales volume and value of share price by manipulating accounting data;
- to achieve external expectations. Employees and clients at the same time are interested in the economic entity's business continuity and its long-term survival, suppliers want to be ensured that debts will be paid at maturity and that contractual relationships with the economic entity will continue on the long-term. Also, the economic entity is interested to be subsumed to analysts' forecasts;
- to manipulate the results. Economic entities wish to show a stable income so that investors are not worried about fluctuations, and that shares do not fluctuate, but be stable;
- to take advantage of the opportunities of accounting to record taxes as low as possible.

Another attempt to achieve a synthesis of reasons for resorting to creative accounting is found with Jones, who made the following classification (Jones, 2011, p. 33):

- personal incentives – granting certain bonuses, salary increases, job security, personal satisfaction;
- external expectations – analysts' expectations achievement, tuning profits, employment in existing rules;
- special circumstances – new issues of shares, loans management, mergers and acquisitions, new management team, waiting for better times;
- covering fraud – misappropriation of assets.

3. Main Players in Creative Accounting and Pressures They Exert

As shown above, managers are the first to be interested in how the entity's financial performance affects their image, influences client relationships and competitive behaviour.

Kirschenheiter & Melumad show that rational managers use financial reporting possibilities with the intention of trying to increase to the maximum the value of the economic entity, within legal requirements and normal accounting practices. (Kirschenheiter & Melumad, 2002, p. 780).

A study conducted by Ernst & Young in 2002 (Young, 2002, p. 11) reveals that 85% of fraudsters were employees at those companies, and 55% were from the ranks of management. It also notes that 85% of managers who were the authors of the greatest frauds had less than one year in office.

The concept of creative accounting has developed over time under the pressure of users, such as managers, auditors, regulators, analysts, shareholders, banks and others (Jones, 2011, p. 21).

Managers are the first to be interested in using creative accounting techniques, wishing that the financial statements reflect the financial situation of the economic entity in a manner most favourable to them. Managers take professional advice from other stakeholders, such as commercial banks, using the possibilities of creative accounting which, although falling within the existing legal regulations, actually exceed their spirit. Regulators also seeks to limit the use of creative accounting by the measures they take through rules and regulations. Therefore creative accounting determines how accounting rules and regulations will look, only to have these new accounting rules and regulations in turn influence creative accounting techniques.

The main players of creative accounting are ***managers*** who use the techniques and possibilities of creative accounting in order to try to influence the way in which reality is reflected in financial statements. For economic entities whose share capital is held by shareholders, managers have a role of administrators, serving the interest of such shareholders. However, in practice, these managers try to make the most of the flexibility offered by creative accounting to achieve their own interest, thus influencing the result in the desired manner. Incentives they can get for the work performed often make them either manipulate profits, try to increase the value of assets or decrease the value of liabilities.

Investment analysts survey financial results of economic entities so as to obtain assurance that the share price is correct. To do this, they must possess the requisite knowledge to enable them to detect the existence of creative accounting and even the existence of fraud. These analysts should be independent of the economic entity under review, but in reality there are situations where this does not happen. Thus, commercial banks, employers of these investment analysts, advise economic entities in their other activities. As a result of this, these analysts may prepare favourable reports, thus obscuring some aspects that could cause existing shareholders to sell their shares in the economic entity concerned.

Regulators want to control the possibilities of using creative accounting. To reflect a true image, accounting regulations are designed to ensure flexibility in their application. International accounting rules, as well as the national ones, have evolved also as a result of accounting scandals that have occurred over time; new rules have been introduced to prevent the emergence of new scandals. As a result, regulators are in an endless battle with "creative" accounting professionals. Most times, regulators are hampered by the fact that "the very high accounting flexibility that is essential to provide an accurate picture is that which can be used by the creative accountant to provide a creative image"(Jones, 2011, p. 25).

Auditors are in turn affected by this creative accounting, and especially fraud, as a result of the fact that they need to express an opinion on the fair representation of the results of an economic entity. Auditors have to issue a qualified opinion if they find irregularities. There is, however, a delicate situation. If the economic entity's auditors will issue a qualified opinion, by this may they may decrease investors' confidence and accelerate the economic decline of the economic entity. Also, thinking in terms of auditors' earnings, issuing such opinions can result in the future loss of that economic entity as client. Auditors will seek to build on existing accounting regulations when issuing an opinion, which might affect their reputation as a result of failing to detect creative accounting techniques, and especially detect fraud when it occurs. To be able to determine existing errors, especially fraud, auditors should possess sufficient independence from clients, enabling them to give an opinion without being influenced by any factor. Yet auditors are paid by the management of the economic entity, being called to issue a report addressing the economic entity's shareholders.

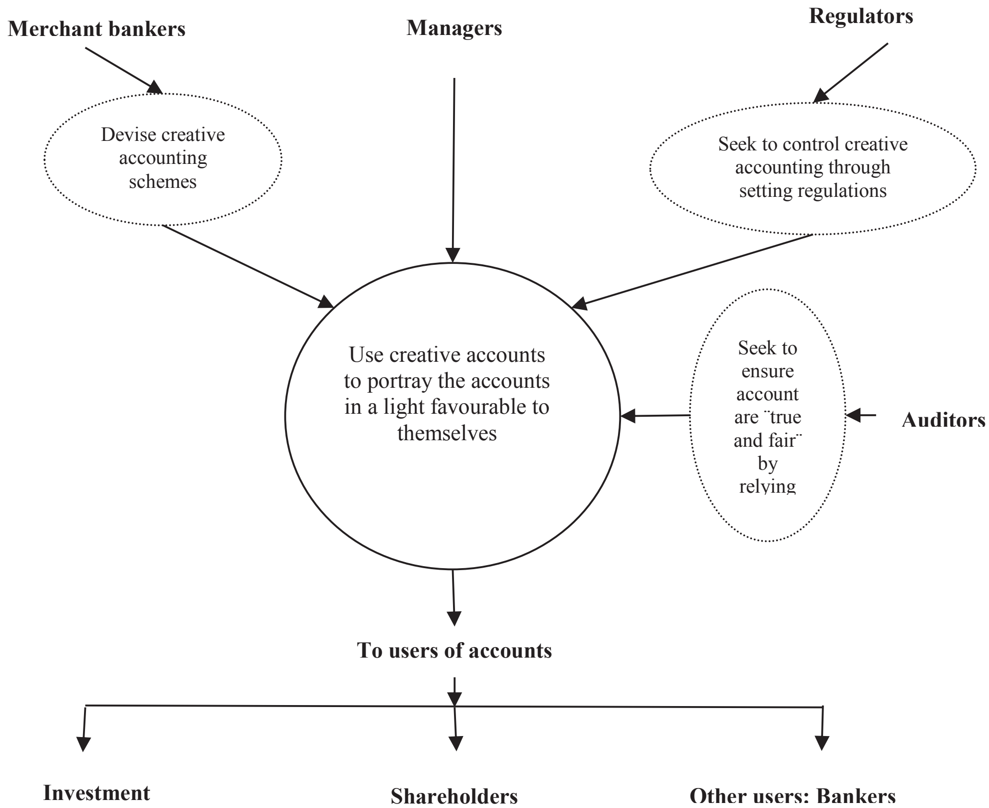
Regarding ***the shareholders***, they may consider creative accounting as a positive or a negative thing for them, because due to the fact that on the short-term creating a more "embellished" image may increase artificially the price of shares owned; but they may also be concerned about the possibility that the economic entity will no longer be able to continue doing business in the future, therefore causing them to lose their money invested in shares. There is a difference between external stakeholders and internal ones, such as, for example, managers. Most of the time, external shareholders do not hold information about the real situation of the economic entity, unlike internal ones, which have the ability and time to sell their shares held in the economic entity they work for, thus managing to avoid any financial loss.

In some cases, ***commercial banks*** have a role in providing "advice" to clients in "embellishing" the overall image of its clients, thus allowing meeting the terms for the repayment of loans.

The category of ***other users*** includes employees, clients, etc. This group of users is based on the fact that financial statements give a true and fair view of the financial performance of the economic entity, and that true image is not affected by techniques available to creative accounting, which does not serve the interests of these stakeholders, but rather attends to managers' needs. Thus, providers give commercial credits to economic entities, being misled by a good statement of cash flows, only to realise later that this image is false. Similarly, bankers grant loans to economic entities, misled by the favourable image provided by the economic entity's financial statements, an image again false, which is not representing the existing reality.

This connection between the main players of creative accounting is as follows in the next figure.

Figure 2
The parties to creative accounting



Source: Jones, 2011: 22

Summarising the above, we find that managers, commercial banks, regulators and auditors use creative accounting to present accounts in a favourable light in relation to financial analysts, shareholders and other users of financial statements.

4. Conclusions

Parties involved in this creative accounting have different interests. Some try to profit from the use of creative accounting techniques and even manage to do this, while others are affected and try to reduce the possibilities of using these techniques. We can say that managers are the biggest beneficiaries of creative accounting, which enables them to manipulate financial statements in order to reflect the economic entity's financial situation in a manner most favourable to them. In addition, it is noted in recent periods that banks were able to take advantage and even develop creative accounting techniques, trying to embellish clients' financial results, being directly interested due to the fact that this way they were able to maintain higher commissions by keeping and increasing the number of clients.

Unlike them, we see that there are some parties affected negatively by creative accounting techniques. Also the use of creative accounting is closely related to the economic environment in periods characterised by financial difficulties: entities' management is tempted to manipulate financial results, and can thus very easily turn creative accounting into fraud.

Acknowledgments:
This work was supported by the strategic grant POSDRU/ CPP107/DMI1.5/S/78421, Project ID78421 (2010), co-financed by the European Social Fund within the Sectorial Operational Program Human Resources Development 2007 – 2013.

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