

CREATIVE ACCOUNTING - BETWEEN THE TRUE PICTURE AND THE ACCOUNTING FRAUD

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***Abstract:** Most users of information, having a special confidence in accounting, imagine it as an exact science, similar to mathematics. In reality accountants, relying on the possibility offered by the accounting rules, often appeal to techniques of creative accounting, that are at the edge of legal regulations, in order to transform synthesis documents from what they should be in what managers want. Although some experts consider it to be a stimulus for the development of accounting, as the accounting rules allow certain alternative treatments, creative accounting is perceived as a negative phenomenon. Financial scandals that rocked the entire world are not foreign to the use of creative accounting practices. In order to overcome this situation that damaged both companies and users of accounting information, experts recommend creating an **organizational culture** by observing that they could get a more objective picture on the economic activity. In this way, they could create the premises for increasing confidence in accounting but also in the honesty of businessman.*

***Key words:** accounting information, legal regulations, creative accounting practices, financial scandals, corporate governance.*

***JED Classification:** M 40, M 41, M 42, G 34*

INTRODUCTION

Nowadays, nobody doubts about the essential role the accounting information has in the economic life. Due to the globalization of businesses, the need for information is much faster and more diversified, which requires special efforts to find solutions that satisfy the needs of an increasingly demanding wide range of users from the information providers.

At micro level, the accounting information reflects the state of a company at a given time, the evolution of the economic activity, the extent in which the business is profitable or not, and provides managers and other stakeholders an overview of the economic entity. Today, more than ever, due to the globalization of markets, the classic financial informing, articulated around the concepts of accounting, is not sufficient as does not entirely respond to the expectations of different categories of users. Often, the accepted accounting principles caused distortions that have deformed the economic reality, the diversity of accounting practices making difficult to approach the financial analysis, especially for multinational companies.

HANDLING FINANCIAL INFORMATION LED TO THE APPARITION OF CREATIVE ACCOUNTING

The development of capital markets and their efficiency depend on public's confidence in a transparent accounting information, which should be accompanied by the clear assumption of responsibility on the financial situation, especially as through the scandals that have shaken many countries of the world, the recipients' confidence of financial statements in financial reporting and auditing was affected considerably.

„Although financial information is produced in a legal framework that governs in a quite accurate manner its presentation rules, we usually find that it is practiced a

correction of the result and a legitimate and legal adjustment of the balance sheet by many companies who profit of the flexibility of legal and accounting rules from where the concept of creative accounting derives. "

The first clues about creative accounting emerged in the Anglo-Saxon literature of the 70's, through the translation of the English phrase "creative accounting". In 1973 the British scientist J. Argenti established a direct link between creative accounting, business decline and managers' ability to conceal certain inconvenient aspects of their business.¹ Creative accounting was developed, especially in the Anglo-Saxon countries, due to the liberty of the accounting profession that offered in addition to basic treatments, also alternative treatments. In these circumstances, accountants were tempted to intentionally choose those variants matching employers' interests, to create a convenient image for their companies to shareholders, investors, etc.. This situation created distortions in terms of quality of accounting information, providing a rather embellished picture of the company and not one that reflected the true reality.

The full description of creative accounting was carried out by Naser, who defines it as:

„- the process by which, given the existence of gaps in the rules, the accounting figures are manipulated and, taking advantage of flexibility, they choose those manipulation and information practices that allow the transformation of synthesis documents from what they should be, into what managers want;

*-the process by which the transactions are structured in such a way as to allow obtaining the desired result. "*²

The used practices of creative accounting are characterized by excessive complication, which aimed at favorably presenting the financial position and the performance of the company in front of different users of accounting information.

Speaking of creative accounting, Ian Griffiths argues that *every company arranges its profits. Each set of published accounts is based on records that were more or less face lifted. The figures that were provided twice a year to investors were all changed to hide guilt. It is the biggest trick of the Trojan Horse ... In fact, this practice is totally legitimate. It's creative accounting.*³

According to Gilet, creative accounting consists of the *"assembly of techniques, choices and freedoms of accounting texts without moving away from the rules and accounting exigencies that give business managers the ability to juggle the result or change the appearance of the synthesis accounting documents. "*⁴

CREATIVE ACCOUNTING - A GOOD OR A NECESSARY EVIL

L. Malo and H. Giot support the idea that we should not automatically assimilate creative accounting with something negative or perverse, as the accounting innovation is needed to keep pace with economic, legal and social developments. In doing so, they show that *"at its origin, creative accounting is virtuous as it offers to accounting resources to enable it to keep pace with the increasing development of markets and the proliferation of financial products. The problem arises from the fact that the businessmen' instinctive perversity begins to rapidly develop. "*⁵

We ask ourselves that if the company advertises *"its products using images or phrases often pushed to the legal limit, without being accused of breach of professional*

¹ Argenti J., *Corporate Collaps: The Causes and Symptoms*, Mc Graw Publishing House, Hill Book Co Ltd. Londra, 1976

² Naser K., *Creative financial accounting: its nature and use*: Pretence Hall, New York, 1993, page 59

³ Griffiths I. *Creative Accounting How to make your Profits what you Them to Be*, International Thomson Business Press, 1987

⁴ Gilet P., *Comptabilité créative: le résultat comptable n'est pas ce qu'il était*, Revue française de gestion, novembre-décembre, 1998, page 83

⁵ Malo L., Giot H., *L'élasticité du résultat selon les dimensions temp et espace*, A.F.C. Congress, 1995

or legal precepts¹ why, in the view of some, it would be illegal to promote its company through the face-lifting of accounting information? Most users of accounting information agree that there are as many truths as recipients of accounting information. In conditions in which, in the opinion of M. Capron "*accounting allows you to reach a formal truth, which is based on several postulates, conventions, regulations and classification rules*" in reality "*accounting is not the magic revealer that some expect.*"²

Whether we accept it or not, creative accounting is used, more or less, by most companies as a means of protection from the action of the disturbing factors that they have to cope with in a globalized economy in which we know that others do the same. Bernard Colas comes to support this assertion, saying that *it would be wrong to believe that regulating and normalizing objectively describe the portrait sheet of a company. They explicitly reveal only the manner in which the portrait was painted. On the other hand, they allow account tutors a leeway that they can use depending on the considerations arising from the financial and communication policy of the company.*³

WHY HAVING RECOURSE TO CREATIVE ACCOUNTING?

Experts in the field agree that all companies use more or less creative accounting techniques to improve their business image and business results. Thus, I. Griffiths finds that "*no financial manager affords not to use creative accounting ... The times when the accounts of a company reflected only performances are long gone.*"⁴

To get to know the reasons for resorting to creative accounting practices we should start from the financial information presented in the synthesis documents and reports and by asking who their users are for trying to make a hierarchy in terms of their interest in the company, or rather say their manager.

According to the manager, investors are the most important users of accounting information and, in order to attract them, information must be presented to prove both the high profitability of the company as well as its rising trend.

To this end, companies proceed to **smoothing results**, which consists in the presentation of a trend, "*of steady growth of profit, than to show volatile profits that successively increase or decrease, dramatically.*" Therefore, in the years with better results, provisions and adjustments are constituted more than is necessary, in order to be used in weaker years, thus improving the "grooming" of the overall situation of the company."⁵

Another category that uses the accounting information of the company is represented by banks when they grant loans, try to estimate how accurately is the risk of not receiving and interest rates on loans at due date. The remuneration that the company will pay to the bank will be directly proportional to the degree of risk that the granted credit involves. That is why, through manipulation of figures, the company is interested to submit a good statement to the bank, with low-risk, making the solicited credit cheaper

Information on the results of the company are required also by tax and control authorities, that verify the correctness of the calculations on taxes that the company owes to the state budget. For this purpose, the creative accountant will seek to reduce incomes and increase deductible expenses. One of the most used techniques of maximization of expenses is the artificial inflation of expenses for doubtful debts, an

¹ Dobroțeanu C.L., *Confluente macro si microeconomice in contabilitate*, Economic Publishing House, Bucharest, 2005, page 98

² Capron M., *Contabilitatea in perspectivă*, Humaitas Publishing House, Bucharest, 1994, pages 140-141

³ Citat preluat din N. Feleagă și L. Malciu – *Politici și opțiuni contabile*, Economic Publishing House, 2002, page 202

⁴ Griffiths I., "*Creative accounting*", Rutledge, London, 1992, page 2

⁵ Dumitrescu A. S., *Contabilitate creativă : dela idei la bani : cu exemple practice*, Economic Publishing House, Bucharest, 2014, page 35

operation aimed at lowering the tax base and thus the income tax due to the state budget.

The employees of a company are interested in information on the size and stability of wages and career prospects on medium and long term. To do this, when interested, *"the manager of the company will evaluate the losses to justify such measures ... of wage compression. The accounting documents shall be presented to the inspector of employment to convince him that the downsizing projects are the only possible solution for the survival of society.*" In these circumstances, we believe that most employees would agree that their only chance of staying in business is to accept the wages that the manager decided to pay."¹

PRACTICES USED BY THE CREATIVE ACCOUNTING

Accounting arose from the need to have a clear situation of everything happening economically and financially in a company, which offered at the beginning prestige and trust of users of accounting information. *"Over time, however, more and more scandals that erupted because of infringement of regulations... have tarnished the immaculate image of all accounting phenomenon."*² In this context, users of accounting information are interested in the opinions of specialists who study the implications of using creative accounting practices in order to detect situations that are not reflecting reality and the true image of a business activity and may lead them into error. Mulford and Comiskey support this information, quoted by Dumitrescu AS³ who divides creative accounting practices into five categories:

1. recognition of premature incomes;
2. aggressive capitalization policies of expenses and of utilization of extended periods of depreciation;
3. erroneous reporting of assets and liabilities;
4. creativity manifested in profit and loss;
5. issues related to reporting cash flows.

1. Recognition of premature incomes;

This practice of creative accounting aims the managers' desire *"to make the sales revenues look more promising."*⁴ One example is the situation in which the company records revenues from the sale of goods, for which they issued the invoice, but have not yet delivered the products. Another example is one in which a company entirely receives commissions in the year when the service contract was signed and record them as incomes, although services will be provided for a period that exceeds one year, which does not reflect reality. Correct it would be if incomes were recognized in profit and loss gradually throughout the contract, within the provision of services.

2. Aggressive capitalization policies of expenses and of utilization of extended periods of depreciation

This practice of creative accounting consists in relieving the profit and loss of an expense that is capitalized by creating an fixed asset or increasing the value of an asset, situation that will affect expenses with a lower value, respectively the depreciation of fixed assets throughout their functioning. Another method that enables cost reduction by reducing expenses is increasing the duration of amortization of intangible assets (research and development expenses, software expenses) and physical assets (buildings,

¹ Capron M., Contabilitatea in perspectivă, Humanitas Publishing House, 1994, page 141

² Voinea M.M., Contabilitatea- o reprezentare normativă a realului economic?, A.I. Cuza University, Intercultural management, vol. XV, no.2(28), Iasi, 2013

³Dumitrescu A. S. , Contabilitate creativă : dela idei la bani : cu exemple practice, Economic Publishing House, Bucharest, 2014, page 51

⁴ Idem, pag. 52

machinery, equipment, etc..) so that, although the total expenditure remains the same, expenses for a shorter period (month, quarter, year) are lower.

3. Erroneous reporting of assets and liabilities

In connection with this practice of creative accounting, Mulford and Comiskey think that claims, stocks and investments, ie assets that are not subject to amortization, may be reported incorrectly. Thus, by the overvaluation of these assets, costs and implicitly losses are reduced, which damages the image of the true outcome. For example, by overestimating the degree of collecting claims, costs with adjustments for the impairment of claims to customers are reduced. Another example is not reducing the value of assets, although in reality their market value has decreased, which has the effect of postponing the recording of losses that also does not lead to a true and fair view. Another example is the undervaluation of stocks purchased and debts to suppliers, which has the effect of artificially lowering costs, a situation that determines an unreal increase of benefits.

4. Creativity manifested in profit and loss

One of the methods of "face lifting" the profit and loss account is represented by including a tremendous income such as the income from the collection of insurance policies in case of natural disasters into the category "Other incomes from exploitation", which distorts the current result, by increasing it, without affecting the total result.

5. Issues related to reporting cash flows

Knowing the preference and appreciation investors have for companies that show higher cash flows generated from exploitation activity, managers can manipulate these flows in the direction of including the events related to financial or special activities into the category related to exploitation activities. This way, cash flows of exploitation activity will increase and the company can "boast" with its exploitation activity, although the reality is different. The situation can be also manipulated in the opposite direction, by the consideration of operating expenses as expenses for investment, such as expenses for software, that by funding, can be considered investments, although in the reality they are exploitation expenses. It is obvious that, overall, the cash flow statement is the same, but per components, using creative accounting, it was managed to get an image as the manager wanted and not like it is in reality.

As a conclusion to the five shown practices of creative accounting, we can say that although subtle and at the borderline of legality, these practices can be detected by specialists so that they can **rebuild themselves** a true and fair view of the company they are interested in and they can make better decisions as investors, shareholders, customers, competitors, financing banks, business partners, tax and control bodies etc.

CREATIVE ACCOUNTING AND CORPORATE GOVERNANCE

In a general understanding, corporate governance represents all systems and processes implemented for the management and control of a company in order to increase its performance and value. At the same time, corporate governance is a tool that can help to maximize the company's value.

*The connection between creative accounting and corporate governance has been much debated within specialized literature as creative accounting emerged amid the weaknesses of corporate governance.*¹ Major corporate scandals occurred at the beginning of this century, that significantly contributed to the global economic crisis, come to support the idea that the failure of corporate governance was a major factor that triggered the crisis. Corporate governance has emerged and developed in response to a

¹ Dumitrescu A.S., *Contabilitate creativă : dela idei la bani : cu exemple practice*, Economic Publishing House, Bucharest, 2014, page 165

series of spectacular failures in the private sector in a short time, leading to loss of investors' confidence in the the ability of managers to lead large companies.

The scandals begun once with the collapse of the giant Enron, which practically became a symbol of corporate fraud, have created a sense of unease and a lack of confidence on the international capital market. In this context, there were questions about investors' confidence in the accuracy of the information provided by companies and by the capital market.

„In response, governments and different competent bodies have initiated various changes, tightening laws on corporate governance and particularly introducing sanctions aimed at forcing companies to adopt ethical and transparent policies .”¹ In this respect, most developed countries introduced new regulations in the already existing Corporate Governance Codes (the Code Cromme of Germany, the French Financial Security Law, Sanbanes Law - Oxley in the U.S. and so on).

As a result of EU concerns for improving the corporate governance mechanisms, on December 12th, 2013, the European Economic Community adopted an **Action Plan on Company Law and Corporate Governance**, whose provisions are necessary in order to implement a modern legislation for sustainable and competitive companies. This document aims to achieve the following objectives:

1. increasing transparency between companies and shareholders, which will be achieved by:

- increasing the transparency of companies in terms of the diversity of management boards and risk management policies;
- better reporting of corporate governance;
- better identification of shareholders by the issuers;
- strengthening transparency rules on relation to policies of institutional investors in the terms of voting and engagement;

2. taking actions to encourage :

- a greater transparency regarding remuneration in general and individual remuneration of board members, as well as shareholders' right to vote on the remuneration policy and the remuneration report;

- extended right of shareholders on the supervision of related party transactions, meaning transactions between the company and members of the board of directors or major shareholders;

- creating proper rules of conducting business for vote councilors (ie companies that provide services to shareholders, in particular vote consultancy), especially in terms of transparency and conflicts of interest;

- clarify the concept of "concerted action" to facilitate the cooperation between shareholders regarding corporate governance matters;

- exploring the possibility of encouraging employee shareholding.

Within a company, the main responsibility for implementing corporate governance lies in the first place to shareholders and managers who through the Management Board shall identify sensitive issues, seek their causes, treat them fairly and responsibly and not superficially, to cope with the disruptive action of endogenous and exogenous factors in order to increase the performance and value of the company.

In Romania, corporate governance appeared in 2000 and the first corporate governance code was adopted in 2001. In 2008 it was replaced by a new code of corporate governance that is based on the OECD Principles and brings improvements designed to satisfy the users of accounting information. This code came into effect starting with 2009 and it is applied voluntarily by companies traded on the regulated market. Companies that apply this code totally or partially are required to prepare a

¹ Miu A., Guvernanta corporative – strat birocratic sau nou instrument de creare de valoare, www.ensight.ro

Statement of compliance or non-compliance which presents the recommendations that had been implemented and the method of implementation. In order to improve the corporate governance code, sustained efforts from the government, experts in the field and in the business environment are necessary, to align the Romanian corporate governance practices to the modern ones, which have proven effective in the developed countries. In this way we will create the prerequisites in order to increase the confidence of users of accounting information on Romanian economy's ability to make progress.

CONCLUSIONS

Whether we accept it or not, creative accounting is used in more or less by most companies as a means of protection from the action of perturbing factors in an increasingly globalized economy. Creative accounting practices, achieved by "face-lifting" of accounting information, aimed at presenting a business activity in a more favorable light. Using these methods shows that managers who are found under fiscal pressure, seek solutions that are advantageous for them, ignoring the question of compliance with some ethical standards.

Standing at the boundary between legal and illegal, being considered an unfair practice, creative accounting does not implicitly mean fraud. To overcome this situation, most experts recommend creating an organizational culture through which it is possible to achieve reasonable estimations that will produce an objective image on the activity of a company.

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