IS CREATIVE ACCOUNTING A FORM OF MANIPULATION?

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Abstract: Manipulation of financial information which is called by several terms such as earnings management, income smoothing, creative accounting practices, aggressive accounting or account manipulation, prevents the allocation of resources in the most efficient areas in the economy. The scope of this paper is to relate the causes, the main motivations behind their application, the objectives, the methods and the consequences of manipulation in financial reporting. Creative accounting is not a new technique, but it can be seen as a costly one. Businesses feel the pressure to appear profitable in order to attract investors and resources, but deceptive or fraudulent accounting practices often conduct to drastic consequences.

Key words: creative accounting, window dressing, fraud, account manipulation

Introduction

Accounting manipulation is defined as when the managers of an organization intentionally misstate their financial information to favourably represent the entity's financial performance. Managers of nonprofits organizations may have incentives to manipulate their reported program-spending ratios because donors use them in determining contribution decisions.

Accounts manipulation represents the use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of capital) or managers (compensation plans). In the first two cases, the firm benefits from the wealth transfer. In the third, managers are acting against the firm. Figure 1 summarizes the principles of accounts manipulation.

The accounts manipulation has a direct influence in modification of the apparent performance (as measured, for example, by the earnings per share) and/or a modification of the company's financial structure.

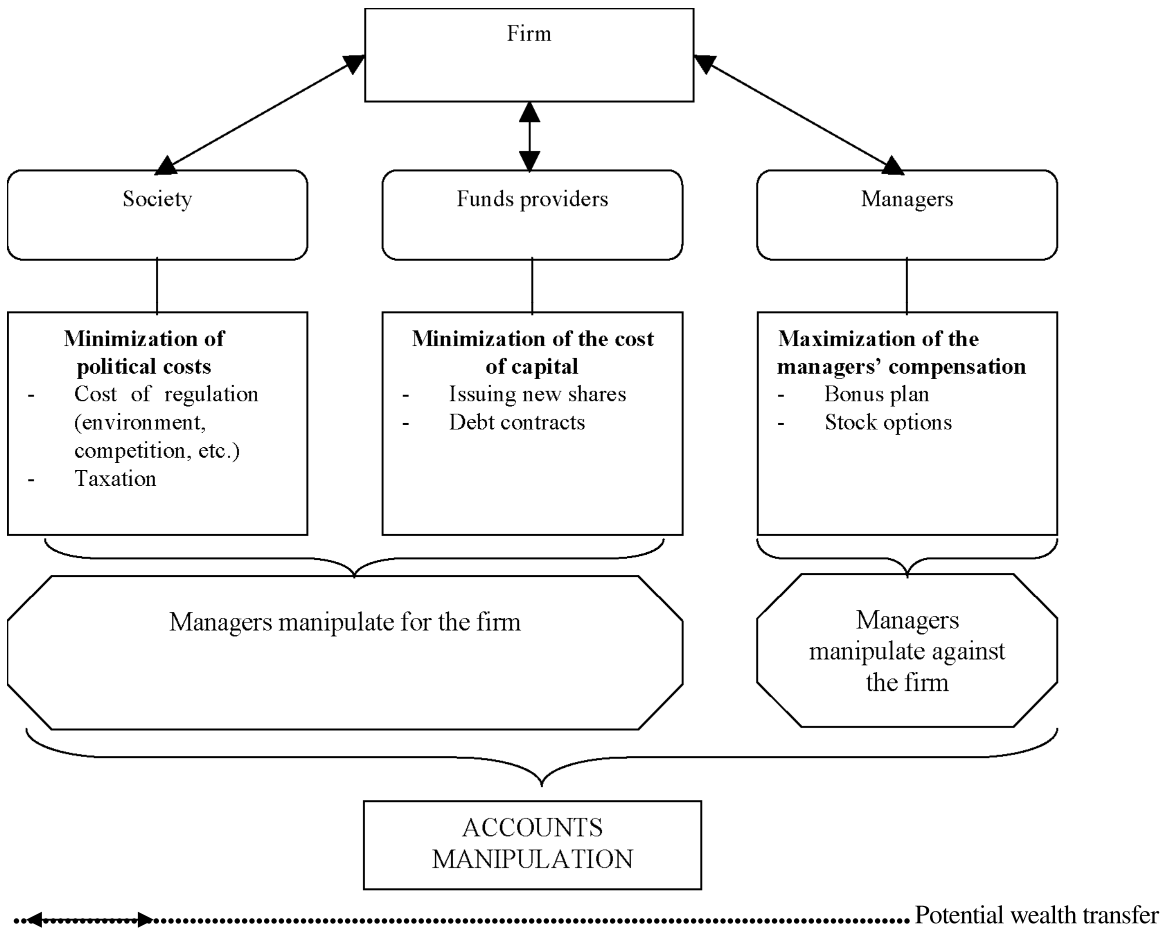

Figure 1 - Principles of Accounts Manipulation

Theoretical Aspects of Creative Accounting

In spite of the fact that the concept of creative accountant is frequently used in business literature, we cannot say that there is a definition generally accepted.

Some authors consider creative accountant 'an assembly of techniques, options and freedom room left by accounting regulation, without moving away from laws or accounting requirements, allowing to the managers to change the financial result or the financial statements' face'(Gillet, quoted by Shabou and Boulila Taktak, 2002). Others see creative accountant as 'an assembly of procedures in order to change the profit, by increasing or decreasing, or to misrepresent the financial statements, or both of them' (Stolowy 2000).

The development of economical, juridical and social activities and the stress of financial information users made the accounting innovation a necessity, and furthermore the development of the creative accounting. This type accountancy evolved in Britannic economies due to the freedom ensured to the accounting professionals and presently lies between legal form and the core of transactions or events. From the practitioners' view, the creative accounting development was encouraged by the base and alternative treatments permitted for solving one issue. Generally, an accounting issue can be solved in at least two methods, each of them with different effects on the company's financial position and performance. The academicians consider the creative accounting was encouraged by the flexibility of the regulations.

As IFRS 1 'The financial statements' reporting' in order to bring out and to present the right financial information, the following conditions have to be taken into account;

- The concordance with IFRS stipulations;
- The possibility to depart from IFRS, if according to the stipulation the right information is not obtained;

- The reporting of additional information in order to present a complete image of transactions and events.

Generally, the creative accounting is badly treated, as a negative creation, designed to prepare the financial statements in order to respond managers' requirements regarding the company's financial position and performance. Therefore, the financial statements are rather a misrepresentation of the company's performance that a true reporting.

The negative treatment of creative accounting does not exclude the positive one, being considered as an innovation that leads to engineering capable of responding the question: How can we administrate the resources in the most efficient way in order to build performance?

Simultaneous treatment of creating accounting as an instrument to accomplish the accounting interests, but also as accounting engineering, depend upon accounting policies agreed. According to IFRS 1 'The financial statements' reporting', the accounting policies represent the specific principles, fundamentals, rules or practices used by the company's management in order to bring out and to present the financial information.

Choosing the best accounting alternative to reflect accurately the reality and company's interest depends on the creative accounting. As a result, some authors consider the Britain window-dressing practice as form of creative accounting. This technique consists in realizing operation that lead to profit or loss, depending on the interest. Different accounting policies lead to different results. In this respect, it is considered that there have to be chosen that policies able to report:

a) significant information for business decisions;

b) believable information able to

   b1) report fairly, correctly and honestly the transactions and events;

   b2) reflect the economical substance of the transactions and events, not only their juridical form;

   b3) be impartial against all types of users;

   b4) be cautious, by preventing the overvaluation of the result;

   b5) be complete, through the significance and cost of information.

One of the creative accounting aims is represented by the income smoothing technique. This consists in deliberate using of accounting policies aimed to report a net income series with a low fluctuations within over a period in order to avoid the fairly report to the shareholders. This way, the management pursue to reduce the net income's fluctuations from one period to another.

The multitude of methods used by creative accounting and engineering differ with the substance. Recently the creative accounting was associated with fraud in accountancy and the accounts' lifting as a method in fraud's waiting room.

Even if both the creative accounting phenomenon and accounting fraud appear in companies with financial difficulties and are aimed to misreport, there has to make a difference between them: creative accounting represents the manipulation of the accounts according to accounting regulation and the law, while the techniques that break the law are considered accounting fraud. Therefore, we can conclude that the company using the creative accounting, benefit from the legislative niches and the flexibility of regulation in order to misreport the financial statements.

Consequently, even if the creative accounting use is not an illegal practice, it is clear, that managers in financial difficulties, are looking to solutions, no matter there are unethical. Otherwise, the half truth and the lie can be suspected as fraud.

Techniques of creative accounting

Six main areas are considered the "source of inspiration" for the creative accounting: flexibility in regulation, a lack of regulation, a scope for management that assumed some targets for the future, the timing of some transactions, the use of artificial transactions, but also the reclassification and presentation of financials. It was proved, that even in highly regulated countries such as USA the accounting environment afford, a great deal of flexibility (Largay, 2002; Mulford and Comiskey, 2002). In order to be understood, we proceeded to the detail of these:

1. Flexibility in regulation. Generally the regulation, particularly the accounting regulation permits flexibility in choosing a policy to follow; the International Accounting Standards let the financial management to choose between valuation of the non-current assets at depreciated historical value or at revaluated value. The management may decide the change of the policies, and these shifts are difficult to be identified a few years later (Schipper, 1989).
2. Lack of regulation is meeting in some areas in every domain. In most countries accounting regulation is limited in some areas, for example in Romania there is few mandatory requirements for transactions with futures and stock options or for the recognition and measurement of pension liabilities.
3. Management can use their discretionary position in order to obtain the financial position and stability they assumed; for example, the managers decide the increase or reduce of the provisions for bad debts (McNichols and Wilson 1988).
4. The timing of some transactions offers to the management the opportunity to increase the revenues, when the operating profit is not satisfactory, and to create the desired impression in the accounts. The existing stocks in company's patrimony, that have a significant higher value compared to the historical value, may be sold only when the operating profit is not satisfactory.
5. The artificial transactions are often used in order to manipulate the balance sheet amounts or to move the profits between accounting periods. These transactions are realized by entering in a controlled transaction with two or there parties, one of them, most of the times, a bank. Such arrangements consists in selling of an asset at a higher/lower rate than in an uncontrolled transaction, and then leasing it back for the rest of it useful period, compensating through the rentals the price difference.
6. Reclassification and presentation of financials are relatively less analysed in accounting literature. However, in reality the companies often proceed to make up the amounts in order to obtain good level of profitability, liquidity or leverage ratios. Most of the times, the numbers are smoothly modified in order to improve the investors' perception. As explained by Niskanen and Keloharju (2000): 'the idea behind this behaviour is that humans may perceive a profit of, say, 301 million as abnormally larger than a profit of 298 million'. Their study and others (e.g. van Caneghem, 2002) have indicated that some minor massaging of figures does take place in order to reach significant reference points.

Techniques that define creative accounting are not new, but experience has shown that most of the times may prove extremely expensive. In order to attract investors and to appear profitable to the shareholders, employees, creditors, suppliers and other categories, the companies can decide to misstate the financials; this practise often lead to drastic consequences. The manipulation of the conduct to a mismatch of the financial position and of the results with the "fair presentation" zone, as shown in Figure 2, which implies that the profit will not represent the long-term capacity of the firm to generate earnings.

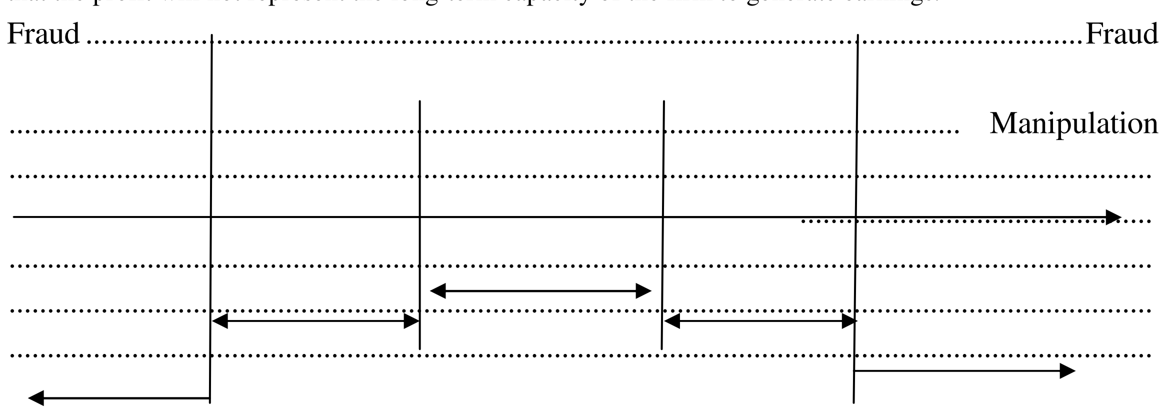

Figure 2 - Accounts manipulation and fair presentation

Reasons and consequences of creative accounting

The conflicts of interest among different interest groups represent the real causes of creative accounting: the managers are interested in paying less taxes and dividends, the shareholders in gain higher dividends, the employees to obtain better salary and higher profit share, the authorities to collect more taxes. It can be easily seen that the interests are tremendous divergent and creative accounting is deepening it. In this respect, David Schiff (1993: 94) has warned the investors that taking a company's financial statements at face value can be 'a recipe for disaster'.

Managing shareholders' interest is to pay less tax and dividends. Investor-shareholders are interested to get more dividends and capital gains. Country's tax authorities would like to collect more and more taxes. Employees are interested to get better salary and higher profit share. But creative accounting puts one group or two to advantageous position at the expense of others. One day the present authors had an opportunity to have a discussion with the Chief Accountant of an enterprise in this regard. The Chief Accountant told, in the course of conversation, that he was determined to retain profit for the expansion of his existing unit and establishment of new ones. Quite naturally, his interest was to pay less tax and less dividend and, accordingly, to 'create' financial statements. This type of creative accounting has led David Schiff (1993: 94) to warn investors; in general that taking a company's financial statements at face value can be 'a recipe for disaster'.

The investors often go wrong by taking into consideration only one ratio, as earnings per share (EPS), ratio that can be 'boosted by the stroke of an accountant's creative pen'. David Schiff (1993: 94-95) considers that there are six main ways used by the companies to increase their earnings: (1) by hidden of the pension liabilities, (2) by capitalizing the expenses instead of writing them off, (3) by realizing an faster increase of the receivables or inventories versus sales, (4) by reaching negative cash flow, (5) by consolidating the affiliates' incomes and net worth, and (6) by following seemingly conservative practice in a situation of reverse direction. Jim Kennan, the Attorney General of Victoria, in a speech before members of the Australian Society of Accountants, pointed out that financial statements, which inflate the financial position and the performances of companies by manipulating the figures (i.e., through creative accounting) should be stamped out, because bring the investor in great difficulties in order to distinguish between the made up financials and the truly financials. We considered this message may be used to stress the main effects of creative accounting:

1. The confusion created among the stock exchange investors, because the figures shown by financial statements are often inflated and the difficulty of investors' to distinguish between the fair and unfair statements.
2. The prospectuses of the listed companies do not always offer a detailed picture the financial positions and performance.
3. The techniques used by creative accounting can "impress£ the investors only over short time periods, while the financial position goes worse, this cannot be hide anymore and these methods are helpless.
4. The long time effect of such practise is the distrust of the investors conducted by the collapse of companies that take advantage of these techniques.

The question we raise is: Are these creative practices always a bad thing or can they ever be justified? As figure 2 shows, manipulation is not fraud. It is a matter of interpretation. This will be a case study of our future research.

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