CREATIVE ACCOUNTING – PLAYERS AND THEIR GAINS AND LOSES

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The aim of this paper is to bring into attention an interesting game of accounts manipulation and its playes. Their expectations represent the genesis point of manipulative behaviour and by understanding their actions and gains and losses we may create a link to undestanding the process of creative accounting thinking. The divergent interests of these users (e.g.managers, fiscal authorities and banks) derive from their position and power, and give rise to doubt regarding the objectivity of accountancy information provided by annual financial reports.

Keywords:creative accounting, manipulation accounts, information users

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Introduction

When and why exactly this concept first appeared and what influenced its development – these are questions that come up when opening this true Pandora's Box: creative accounting.

With hindsight a few favourable circumstances to this concept can be identified, circumstances first related to the economical advent of world states but at the same time to the need of economic entities to create for themselves a good reputation in an increasingly competitive and tough economic environment. About this particular moment, that is - the first mention, regarding creative accounting practices, we can't ignore the fact that the first mention belongs to the founder of accounting - Luca Paciolo. This ambition of making figures more appealing or the opposite, if the case, is as old as 500 years. Thus, Luca Paciolo was shaping in his already renowned De Arithmetica, the first accounting manual, practices of creative accounting.

In the context of brisk Venetian foreign trade, relationships between traders were recorded by double-entry bookkeeping with ink and quill-pen in main and subsidiary books. Where discrepancies arose, the inkwell was occasionally knocked over on these books – not always unintentionally – in order to make the entries illegible. That's the origin of the term "cover-up".

In the context of the world economic crisis nowadays, creative accounting will be referred to more often as a field from where it is expected either to offer live-saving solutions or be blamed for all the negative evolutions. On this aspect, Salustro and Leburn (quated by Delesalle, 2000) would say: „Crisis periods are actually trials for enterprises; affecting their cash flow and generating risks, that accounting doesn't deal with in a flawless manner. Therefore, managers are tempted to resort to ingenious, more often questionable procedures, for refining accounts presentation."

The reality of an enterprise can be mirrored in several aspects, starting from the atmosphere and the environment where the employees perform their daily activity, through the company's brand and to the yearly financial statements. This reality, though, seen from the perspective of the external environment, capitalized in clients, suppliers, public institutions, banks, investors etc, is strongly influenced by the subjectivity of the one watching.

This approach of the accounting informing system may seem absurd due to the fact that the information of the financial statements are some figures, some values which apparently cannot be misunderstood. Yet, reading between the lines and making certain connections, several ways to manipulate the information can be discovered.

Actors and their gains and loses in the accounts manipulation game

In the chess parties there are many times when we consider that one of the parts has an important advantage, even though the number of the pieces on the board is the same. To what does this statement owe, otherwise a correct one? Obviously, it is explained through the pieces activity difference. Seldom, during the moments of maximum confrontation of the pieces on the board, one of the parts has more pieces "out of the game". How can we avoid such situations? Simple, taking into account the piece improving principle (according to the Russians, first worded out by Makogonov) who shows that: "in balanced position, when none of the parts has immediate threats, it is necessary to rearrange the pieces, in the worst situation, on a suitable field, or if this thing is not possible, let's try to change them." Of course, there are multiple the situations when we have more pieces out of the game. It is necessary the successive application of this principle, starting with the strongest pieces. What we have presented above seems something absolutely ordinary, we all learn, from first steps on the land of this magical game, that we have "to arrange the pieces on the centre of the board, to be stronger". This does not prevent us, that in the moments of relative "calm" on the board, from forgetting about the application of this principle. Otherwise, subsequently, this thing becomes already hard or impossible to achieve.

As within the framework of this "brain" game we can see the ability of the parts to use the pieces available to them (by complying more or less with the principle worded) in order to achieve the result proposed, thus, by extrapolating our analysis to the case of the enterprises, we can identify certain participants who, according to the levers available to them can shape, more or less, the image of the enterprise.

Specialist literature in creative accounting field refers to agency theory, which relates to the conflicts of interests between users of accountancy information.

An agency relationship comes into being when one party, known as the *principal*, entrusts management of their private assets to another party, known as the *agent*, who has competence and knowledge inaccessible to the principal. The most common form of agency is that in which a manager operates on behalf of a shareholder. From this point of view in the life of an enterprise, we can identify two categories of actors having a special position (Feleagă N., 2006):

- on one side, the shareholders, because their patrimonial rights are not exercised but in the end, after the others, who have rights (creditors, suppliers, employees etc.) have emphasized their debts, the shareholders take the financial risk justifying the appropriation of a part of the year's profit and from the residual net asset, in the case of the entity closing down;
- on the other side, the leaders, because they have privileged information, taking into account the position held in the enterprise and, therefore, are tempted to take advantage by allowing themselves considerable advantages or, generally, by directing the entity towards a direction useful for them. In the case of enterprises quoted on financial markets there is a natural distribution of responsibilities. Such a distribution and the problems arising from it have been presented in the founding papers of Berle and Means (1932).

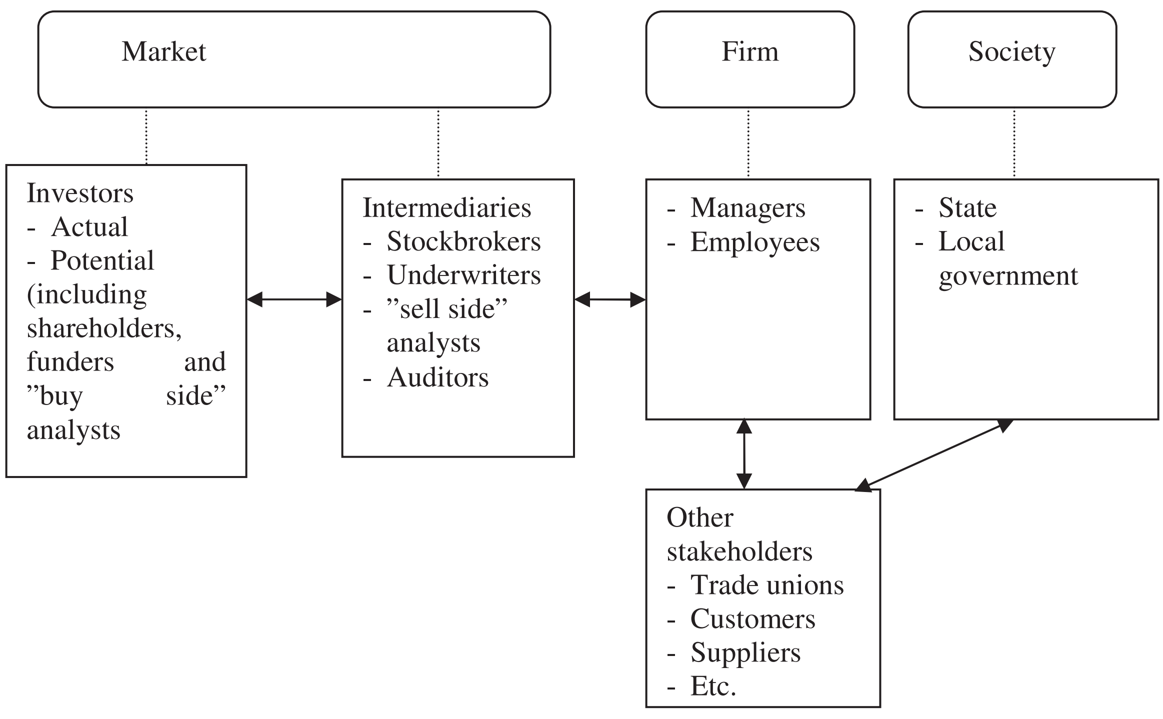
The shareholders invest their capitals and give the leaders/managers a mandate through which they manage the best the organization, trying to maximize the performance of the enterprise. This separation of the responsibility can lead to conflicts generating costs. Manipulating accounting data is an activity reserved to company managers, even though the other players in the field influence the leaders/ managers in their decision to perform such a manipulation. If it were possible to build a theory of the accounting data management, it would not have started from the techniques used for manipulation, but based on the needs, the occasions arising and of the relations between players and investors.

The conflicts of interest among different interest groups is the real cause of creative accounting. 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 IASC's framework for the Preparation and presentation of Financial Statements, envisaged by the IASB, presents the following categories of users: current and potential investors, employees, creditors, suppliers, and other commercial creditors, clients, government and governmental institutions and the general public. According to the position of these users relative to the business in question, they may be divided in internal and external users. *Internal users* are principally management personnel within the company. They have responsibility for information release systems, and therefore have access to supplementary information. External users fall into the other categories mentioned in the Framework; according to their authority, they may be able to dictate the nature of the information to which they are privy, as is very much the case with governmental institutions and banks, while other may be unable to have any say regarding the type of information to which they may obtain access, since they lack the necessary authority.

According to Stolowy and Breton (2004) there are a lot of players in accounts manipulation game as we can see in the next scheme:

Figura 1. Players in the field of accounts manipulation



Source: Stolowy and Breton (2004)

The investors can be divided in four subgroups: real and potential shareholders and the real and potential stockholders. Their interests are very varied and the transfers of riches can be operated between these subgroups. Consequently, they react differently to manipulating accounting data.

Analysts can be grouped into two categories: "buy- side" and "sell-side". The studies of Robb (1998) and Kasznik (1999) indicate the role of financial analysts whose issue recommendation and forecasts. According to Breton and Tafler (1995) they normally try to forecast the reported numbers including the effects of manipulation. They make profit if a manipulation raises prices, and furthermore the issues may be easier to sell.

Managers may or may not believe in market efficiency. In case they do not, they can act in order to manipulate the numbers. Their purpose would be to reduce the cost of capital, to satisfy the external demand of existing shareholders, to increase their own remuneration, to decrease the overall risk of the firm, or to avoid violating the debt covenant or incurring political capital costs.

Concerning the *auditors,* two contradictory goals can be seen: on the one hand they want to satisfy the client and, on the other hand they want to avoid excessive risk from third parties. The quality of auditors may also have an effect on the degree of earnings management.

Current investors (shareholders) principally follow the progress of their investments, future profitability and the management's administration and direction of company resources towards their individual interests.

Potential investors follow the likely estimated risk of their future investments, profitability and stability of profits over time, and the long term capacity of the business to generate liquidity.

The public, through the administration of diverse communities, is concerned with the impact of the company's activities upon local economic development, the creation of new jobs, professional training, contributions to the local budget, and environmental impact.

There are many forces that influence the accounts and, more particularly, the profit figure. From the interests of each group arises the motivation to manage accounting figure. These motivations are studied directly and indirectly by many authors. Several have been identified ranging from the managers' incentives to manipulate earnings to the reasons of the other stakeholders (Merchant şi Rockness, 1994). The most important work in this area is the paper written by Watts şi Zimmerman (1986)which proposes a theory for accounting procedure choice containing some essential underlying motivations: the remuneration package, debt covenants and political costs. Finally, Dye (1988) and Schipper (1989), propose some explanations of the manipulating behavior of shareholders based on the positive accounting theory.

Some of these stakeholders groups also have something to lose through accounts manipulation. Although, Revsine (1991) sais that everybody wins, that is not always the case.

Stolowy (2003) identified, on the one side, the potential gains of each group in manipulating accounts and the potential loss for different stakeholder groups because of accounts manipulation, on the other side. We can summarize them as follow:

Table 1. Potential gains and losses in/from manipulating accounts

Players	**Gains**	**Losses**
Managers	Reducing the cost of capital Keeping their job Managing their remuneration Respect the debts covenants Official examination Minimization of income tax Gain tax advantages Improve relations with creditors, employees and investors	The job and reputation

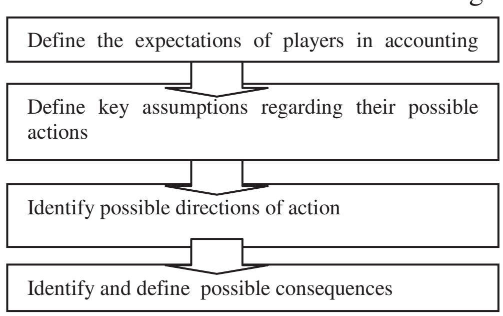
	Avoid political costs	
Existing shareholders	Increasing the market value of their shares Controlling employees claims Reducing the cost of capital Reducing the volume of transaction	Confidence in the market
Existing bondholders	Increase the market value of their bonds Controlling employees claims	Wealth transfer to the actual shareholders
Employees	Keeping their jobs Increase the remuneration	Their job from an unexpected bankruptcy
Suppliers	Keeping their client	Some money following an unexpected bankruptcy
Clients	Continuous services Warranty respected	Services interrupted Warranties not honored
State	Tax to collect Jobs for people	No more tax to collect Unemployed people to provide for
Bankers	Repayment of the loan	Some money following an unexpected bankruptcy
Society	Keeping the job Production of wealth	Jobs lost and resources wasted

Source: adapted from Stolowy and Breton (2004)

Conclusion

Even if creative accounting is not against the law, operating within the letter both of the law and of accounting standards, it is quite clearly against the spirit of both. Creative accounting is a process of using the rules, the flexibility provided by them and the omissions within them, in order to make financial statements look somewhat different from what was intended by the rule. The positive image built with the financial statements help will influence decision making both internal and external (users of accounting information being including here).

We can identify a lot of expected rewards earned by those who play this manipulatative game. Understanding the players in the accounting field demands and expectations is the key to understand the process of creative accounting. If we were to articulate the process of rational reconstruction within the methodological framework that can be used in order to describe the process of charecterize the manner in which their expectations can represent the genesis point of manipulative behaviour, the framework will include the following assumptions:



Source: Elaborated by the authors

Sometimes the desire reward is an upward move in a firm's share price. For others, the incentive may be a desire to improve debt ratings and reduce interest costs on borrowed amounts, or create

additional slack and reduce restrictions from debt covenants. Regarding high-profile firms, the motivation may be lower political costs, including avoiding more regulation or higher taxes.
The question that arise as long as we seek in this field is: Can creative accounting be controlled? Until we'll be able to respond on this question based on our researches we come with the answer of Sir David Tweedie (quated by McBarnet D, Whelan C, 1999) when was asked whether the new regim will win the battle against creative accounting. His respond was memorable: " We're like a cross-eyed javelin thrower competing at the Olympic Games: we may not win but we'll keep the crowd on the edge of its seats!"

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