Within the wide field of creative accounting, the main preoccupation of researchers surrounded earnings management. The current study comes to acknowledge that creative cash flow may distort the assessment of financial performance and should therefore, become a subject of the same interest for analysts and investors, as earnings management is. In order to reach the objective proposed, there are two hypotheses formulated, to be validated within the research:

H1: Creative accounting distorts cash flow reporting within the boundaries of current regulations. H2: Real activity manipulation alters significantly the operating cash flow. The steps followed were analyzing the accounting standard related to cash flow statement, IAS 7, in order to uncover issues not taken into account, or options of allocation provided for accountants, which could lead to opportunistic choices and lack of comparability. The relevant literature was reviewed, so as to identify the opinions of accounting and finance specialists related to this subject, the results of their scientific process. The final step was a synthesis of relevant results and observations, which lead to the acceptance of the hypothesis of the research. Moreover, several techniques were identified, both related to creative accounting and to real activity manipulation, influencing mainly the figure reflecting operating cash flow, and thus the image on the potential of business continuity. Main conclusions were that the techniques applied were within the limits set by the standard: opportunistic allocation of dividends and interest collected or paid misallocation of certain activities like sale of receivables, but mainly recording nonrecurring events into the operating cash flow, without separate notes of information or adjustments. Real activity manipulation should also be considered as it is even more difficult to detect, unless analysis is also performed on notes to financial reports and the figures within the profit and loss account. The contribution of the current study is providing a synthetic argumentation to why cash flow should be analysed in the context of creative accounting, reviewing methods and techniques that distort significantly the results of operating activity, providing basis for further study related to the impact of such practices on forecasts of cash flow and predictability of bankruptcy.

Keywords: operating cash flow, creative accounting, nonrecurring activity, IAS 7, financial performance

JEL Codes: M41

1. Introduction

Creative accounting and the multiple accounting reporting manipulation techniques have been subject to extensive research and study. Recent financial scandals have put under suspicion the quality and accuracy of financial reporting. Most of the studies seem to concentrate, however, on earnings management as the focus for accounting manipulation. An example is the study of Pablo Fernandez (2008) considering that “Cash flow is a fact. Net income is just an opinion”. Like others (Sharma D., Iselin E., 2003, Verbruggen S., Christaens J., and Milis K., 2008), he considers earnings to be a result of various accounting hypothesis, affected by manipulative options (revenue recognition, capitalization of expenses, depreciation method, etc.).
For this reason, the opinion that cash flow statement is less a subject of opportunistic management, is widely accepted. This conclusion has led to lower interest on potential creative cash flow.

The second issue leading to the present study was the decreased comparability of cash flow statement given the freedom of choice related to operating cash flow reporting (direct versus indirect method, allocation of components between the three types of cash flow). This concern generated the idea of potential opportunistic choices.

In this context, the object of the current study is to determine whether creative accounting could affect cash flow reporting to such a degree as to distort and corrupt the assessment of financial performance. In order to reach a conclusion, the study is intended to discover the validity of the following hypothesis:

**H1:** Creative accounting distorts cash flow reporting within the boundaries of current regulations.

**H2:** Real activity manipulation alters significantly the operating cash flow.

### 2. Research Methodology

The first step was to identify the relevant international standards related to cash flow reporting, and the options left for accountants. The main concerns identified were related to operating cash flow and the lack of clear allocation principles for some of its items, as well as the differences between direct and indirect method of reporting (both allowed by the standard - IAS 7).

We have then reviewed relevant literature, mainly articles debating various issues on cash flow reporting, going through approximately 200 studies selected from international data bases. The main ideas and concerns related to creative cash flow have been selected, and afterwards synthetized.

The third step was following the principles of deductive analysis, the general issues being identified, as well as the way they fold on existing regulations, and the impact on cash flow reporting.

### 3. Creative cash flow within the boundaries of current regulations.

The operating cash flow is the key indicator of the company’s liquidity and the capacity to sustain main business. It is no surprise, then, why it has proven to be main target of creative cash flow reporting. Like Mulford C.W and Comiskey E. E. (2005, p. 19) state, creative reporting refers to the steps followed in order to create a distorted image on operating cash flow, by supplying deceiving signals on the financial health of the entity.

*The effect of misplacing items within the report*

One of the first observations was the flexibility of the standard, allowing some items to be allocated so as to boost operating cash flow, being misplaced between operating, investing and financing cash flow.

Mei Luo (2008: 422-423) is preoccupied with what he calls “unusual cash flow”. He detects various cash outflows included into operating flow, like restructuring the activity or research and development, but more related to the investment activity. This misallocation influences the forecast of analysts, expecting these outflows to be recurrent (since they are reflected into the operational section), thus the future results would show an increase instead of maintenance of operating cash flow. Another issue debated by Mei Luo but also by others, is the sale of receivables, that influences positively the operating cash, being actually in substance a cheaper way of financing the activity, and that should be reflective in the financing section. Neil Weiss and J.S. Yang (2007: 2-4) criticize the flexibility of the standard, which allows two choices of allocating interest and dividend payments (either operating or financing cash flow), affecting the comparability of financial reports. Like Mei Lou (2008), they underline the distortion of
perception created by the sale of receivables, similar to a bank loan, but actually boosting operating cash. Weiss and Yang (2008) observe the option permitted by IAS 7 to reflect dividends received as operating (instead of investing) cash flow, thus offering the possibility of big multinational corporations to “play” with high amounts, requiring dividend collection from subsidiaries in order to increase operating cash result.

Nonrecurring elements reflected as recurring through lack of informative notes
A large part of related literature is preoccupied with nonrecurring cash flow, reflected as recurring. Since operating cash flow is “the star”, reflecting the sustainable on-going part of cash, analysts and investors usually predict constant evolution, unless other information is provided, related to changes in activity, increase in production capacity or reduction of activity. Companies may intentionally leave the impression for some transactions with positive result, to be recurrent or assess the ones with negative cash as nonrecurring.

Mulford C.W. and Comiskey E. E. (2005: 211-212) state that current accounting standard does not define the term of “nonrecurring cash flow”, probably considering the end-users will be able to recognize it, if case. They have observed examples where, even if the cash flows are actually recurrent, their value is nonrecurring, inconstant, or may derive out of other activities than the operational ones, considered in theory as recurrent. The two specialists select out of the financial statements analyzed a few examples of nonrecurring elements included into operating cash flow: advance payment of stock, restructuring payments towards suppliers, inflows generated by discontinued activities, inflows and outflows form litigations, collecting business insurance policies, etc. They recommend extra attention to the notes added to financial statements, and to complete the process by also analyzing the profit and loss account. B. Elliot & J. Elliot (2008: 657) assess that the standards should impose a separate reporting of the cash flow necessary for assuring the maintenance of current business capacity from the one necessary for extending the business, because the lack of this information distorts the image upon future performance.

Direct versus indirect method of reporting operating cash flow
IAS 7 offers the possibility to accountants to state the operating cash flow either through the indirect method (deriving from profit and loss figures, adjusted for noncash elements and changes in working capital), or the direct method (reflecting main inflow sources and outflow destinations) of reporting. Since the indirect method is deducted from the results from profit and loss account, it is obvious that the effect of earnings management leaves marks on the statement of cash flow. Like Anne Britton and Chris Waterston (2005: 161) state: if cash flow reporting is wanted, there should be only one method, the direct method. This would avoid confusion in the minds of end-users that may have difficulties in reconciling operational net income to cash flow. Moreover, the cash flow statement could become an efficient instrument in detecting creative accounting techniques applied to accrual figures. Howard Schilit (2003, 203) noted that by comparing operating cash flow to earnings, we should find warning signals in case of high discrepancy. A high net income, opposed to a negative or low cash flow should generate suspicions on the quality of incomes and the potential too high operating expenses. A high value of operating cash flow, though, in the context of low profitability, is another warning that should lead to thorough analysis. C. W. Mulford and E. E. Comiskey (2002) propose a series of actions to be followed in order to correctly compare operating cash flow and income. The authors even recommend new indicators like „adjusted cash flow”. In order to reach this figure, cash flow must be adjusted for nonrecurring events. In this respect, a few elements must be isolated, like cash flow from discontinued operating activities, tax payments that can be classified to financing or investing activities, transactions related to assets held for transaction, capitalized expenses included into period’s operating expenses or other significant isolated events leading to changes in operating assets or liabilities.
4. Real activity manipulation of operating cash flow

Cash flow management is necessary in order to provide the liquidity necessary for business continuity. The managers must supervise the cash collecting systems as well as the current assets management (transformation of receivables and stock into cash). Reider and Heyler (2003: 35-38) define the objectives of an efficient cash control: To insure the availability of cash in accordance with payments; To identify the cash excess in order to invest it so as to generate profit; To account all transactions in order to insure the correct recording of data; To control the cash flow so as to avoid theft or fraud.

Although, this is all true, there are some decisions of cash management that may opportunistically favor the cash flow of a certain period. In this respect, Divesh S. Sharma (2001: 11-12), one of the advocates of the utility of cash flow reporting, underlines certain manipulative management activities like intended delay in payments towards suppliers (translated in increase in cash flow), or stock reduction under normal level, all generating additional operating cash. All these action may signal a company under financial stress. Other types of manipulative actions are artificial increases in investing or financing cash flow meant to cope with the lack of operating results, which could be a sign of probable bankruptcy. Howard Schilit (2002: 199-203), points out the managers that in the context of insufficient operating cash flow necessary for business continuity decide to take measures like fixed assets sale, increase bank loans or excessive stock reduction. G. J. Benston (2006, 478-480), analyzes the reasons behind the bankruptcy of Enron. He noted the artificial increase in operating cash flow by masking a huge bank loan behind a gas delivery contract, or starting up affiliated companies contracting loans, the figures in cash finally helping the ones of Enron through consolidation of financial report. Hugo Nurnberg (2006: 217) identifies another real activity manipulation. He observes how operating cash flow is boosted not through collections related to sales of goods and services or better cost control, but through sale of existing business lines or is diminished not due to payments to suppliers, but to business acquisition. In these cases, at first, the investing cash flow is affected through one time figure, but post-acquisition data influences operating cash flow, including receivables and stocks transformed into cash, from the acquired business. Nurnberg noted examples of such opportunistic decisions, clearly related to the improvement of operating cash flow, in order to fulfill a certain level of financial indicators so as to have access to bank loans, to influence the result of company valuation process or to achieve the objectives set by shareholders.

5. Conclusions and further research

Following the steps proposed of the current research process, we have encountered reasons to clearly validate both of the hypothesis assumed: H1: Creative accounting distorts cash flow reporting within the boundaries of current regulations. H2: Real activity manipulation alters significantly the operating cash flow. By reviewing relevant accounting and financial studies, we have identified clear ways of manipulating the image of a company’s liquidity, thus reaching the conclusion that creative cash flow exists and its detecting plays an important role in determining the accurate financial performance and the probability of bankruptcy, since almost all applied techniques affect the operating cash flow, the fundament of business continuity.

We reflect below, main manipulative actions discovered, affecting operating cash flow, within the limits set by IAS 7:

<table>
<thead>
<tr>
<th>Method</th>
<th>Technique</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creative accounting</td>
<td>Allocating dividend and interest payments to financing rather than operating cash flow;</td>
</tr>
<tr>
<td></td>
<td>Allocating dividends and interest received to operating rather than investing cash flow;</td>
</tr>
<tr>
<td></td>
<td>Reflecting sale of receivables to operating activity (rather than</td>
</tr>
</tbody>
</table>
financing), without even related explanatory notes

- Recording nonrecurring cash flows into operating cash flow, without additional notes reflecting the lack of continuity;
- Misplacing investing flows or hiding financing inflows into operating activity;
- Using indirect rather than direct method of reporting operating cash flow;

<table>
<thead>
<tr>
<th>Real activity manipulation</th>
<th>Excessive sale of stock or unnecessary discounting of receivables;</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Intentional delays in payments towards suppliers;</td>
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<tr>
<td></td>
<td>Forcing investing or financing activity to cope with lack of cash, with positive impact on future operating cash flow;</td>
</tr>
</tbody>
</table>

**Table 1.** Methods and techniques of cash flow manipulation. Source: authors’ projection

The contribution of the current study is a synthetic argumentation to why cash flow should be analysed in the context of creative accounting, reviewing methods and techniques that distort significantly the results, providing basis for further study related to the impact of such practices on forecasts of cash flow. Having in view that a wide majority of researchers consider future cash flow as the best indicator of the probability of bankruptcy, and although current net profit is the basis of such estimation, we have to admit that current cash flow provides significant additional information. The intended future research of the authors’ is actually determining potential manipulation techniques applied by Romanian companies, by analyzing the financial reports made public by listed firms. This will be performed by applying the check list proposed by C.W. Mulford and E.E. Comiskey, in their 2002 research work, ”The Financial Numbers Game. Detecting Creative Accounting Practices”.

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**References**


