

CREATIVE ACCOUNTING THROUGH THE POLICIES AND ACCOUNTING OPTIONS

DIMA FLORIN-CONSTANTIN

“CONSTANTIN BRÂNCOVEANU” UNIVERSITY OF PITEȘTI, F.F.C. PITEȘTI,
2A Bascovului Road, Pitești, Argeș, florin.dima@univcb.ro

Abstract:

The entity's "true and fair view" is reflected according to the financial position, the entity's financial performance and the changes of the financial position and financial performance. The study undertaken by us will be based on the presentation of several accounting policies which determine or influence the entity's financial position and performance.

Although our approach seems pretentious, its subject is cursive, a subject in which we try to combine theoretical aspects with practical examples.

Key words: *accounting policy, accounting option, creative accounting*

JEL classification: *M41 - Accounting*

1. The concept of creative accounting and the motivational complex of developing creative accounting techniques

Despite the efforts to normalize and regulate accounting internationally, the accounting information succeeds in fulfilling its duties only partially. The most eloquent proof is represented by the numerous financial scandals. They are based either on the discovery of some falsifications, or use of (allowed) accounting practices to conceal the real situation. Use of the latter is known as creative accounting or engineering.

The concept of creative accounting can be defined as the process by which professional accountants use their knowledge to manipulate the figures included in the annual financial statements, taking advantage of the possibility of interpreting rules and the existence of numerous options to solve various accounting problems.

Creative accounting involves selecting from a variety of accounting practices to measure and assess those allowing the conversion of financial statements from what they should be to what managers want them to be.

Creative accounting is the process by which the conducted transactions are structured and processed in such a way that will obtain the desired accounting result. This does not violate the accounting laws and rules; it is respecting them, but obviously not their spirit. The fact that they comply with the industry regulations makes a difference between creative accounting and crime or fraud.

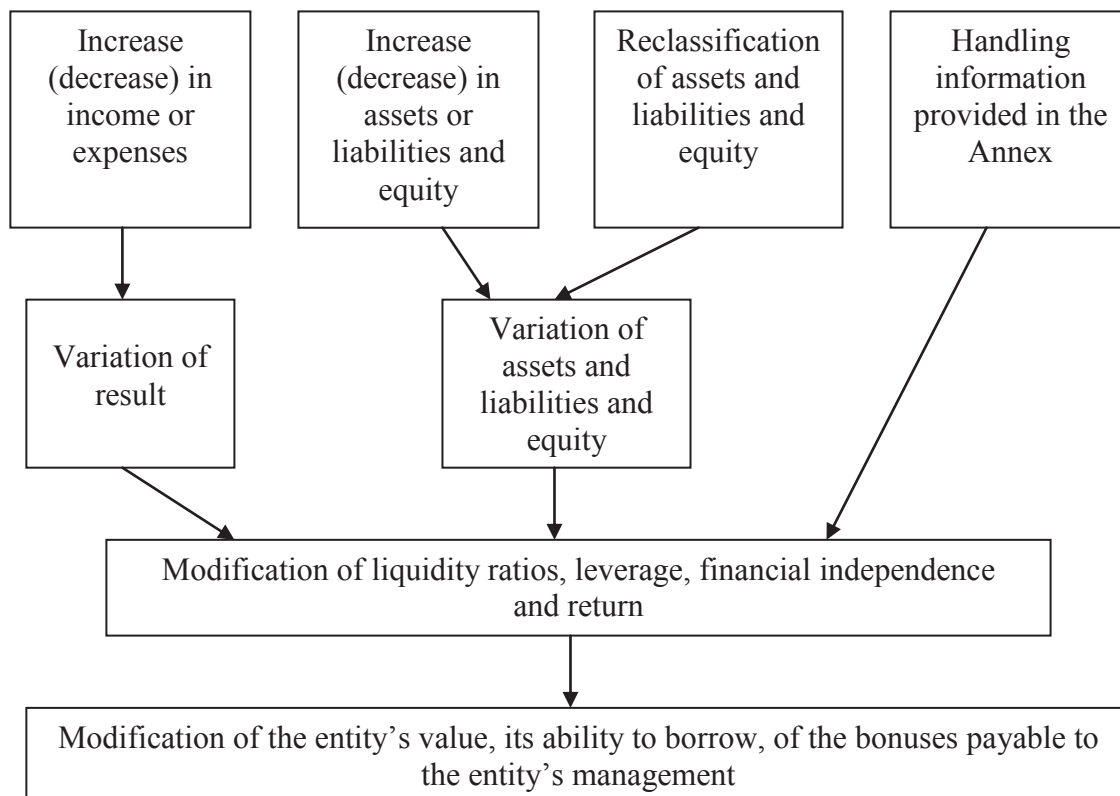
Regarding the premises or the factors that stimulate the usage of the creative accounting techniques, it (they) could be:

- the possibility offered by accounting rules to elect/choose between the different accounting methods. For example, in some countries, the entity can choose between recording the research & development expenses as a non-corporate asset and their integral inclusion in the statement of profit and loss as being considered expenses of the current year;
- the fact that the accounting rules give the possibility for a number of elements to make estimations or predictions. For example, in case of a tangible asset, the entity estimates its useful life for depreciation. Thus, the "creative" accountant has the opportunity to be more "optimistic" or

"pessimistic" to estimate, depending on the purpose. Even more, he can arrange for the services of an expert outside the entity known as being inclined to optimistic or pessimistic estimations, depending on interest.

- the usage of "artificial" transactions, such as the lease-back for smooth results or to manipulate the values in the balance sheet;
- timing of completion of a transaction to project a certain image on the accounts. For example, the year when the it intends to increase its result, the entity's management can sell an asset that has an accounting value of 6,000 mu, and its market value is of 7,000 mu;
- incompetent managers. Managers try to hide the lack of performance by using creative accounting techniques, which leads to the idea that sometimes creative accounting may be associated with failure of the company using it just to postpone the "fatal" day;
- uncertainty and risk generated by the volatility increase of some market elements, such as: fluctuating currency exchange rates, growth rate, correlated with the increase of the inflation rate, etc. In this context, entities are forced (driven) to adopt risk reduction and "embellish" tools for the annual financial statements;
- the attitude of the financial accounting information users to attach an excessive importance to the accounting result and thus to stimulate creative accounting techniques.

Using the creative accounting techniques will have the following effects [N. Feleagă, L. Malciu, 2002, p. 391]: increase or decrease of expenses, increase or decrease of the income, increase or decrease of assets, increase or decrease of owners' funds, increase or decrease of debts, reclassification of assets or liabilities, handling the attached information, presentation of the information. The effects of this can be illustrated as follows:



Source: N. Feleagă, L. Malciu, "Accounting Policies and Options", Economica Publishing House, Bucharest, 2002, p. 391

From the things presented above we can infer the idea that creative accounting implies that the entity takes advantage of the existing loopholes in the rules, and their flexibility to prepare and publish embellished financial statements. Although not illegal, creative accounting indicates that managers are under financial pressure to seek solutions without questioning regarding their ethical actions.

2. Practices of creative accounting

Creative accounting is possible due to the fact that international accounting rules give the possibility of making choices regarding recommended accounting treatment and policies.

The freedom of choice between these options has generated uncertainty about the consistency and comparability of information for users. In the following we will try to illustrate some creative accounting practices and their impact on the entity's performance.

Creative accounting practices related to inventory are based on accounting treatments regarding the stock assessment recommended by IAS 2 "Inventories" [IFRS, 2011, IAS 2], which are valued by professional accountants' creativity. For example, the result desired by the entity's management, the acquisition costs of inventories will be directed to be included or not in the purchase cost.

We consider in this regard that an entity acquires goods in the following conditions: purchase cost of goods 10,000 mu, transport costs 300 mu, revenues from the sale of goods 17,000 mu.

According to the manager's decision to include or not the transport costs in the profit and loss account, the results will be presented as follows:

Extract from the profit and loss account

Elements	Transport costs included in the cost of goods acquisition	Transport costs excluded from the cost of goods acquisition
Revenues from the sale of goods	17,000	17,000
Cost of goods sold	10,400	10,100
- purchase cost	10,000	10,000
- transport expenses	300	-----
- handling expenses	100	100
Accounting result	6,600	6,900

We note that where transport costs are included in the acquisition cost, there is a lower result and vice versa. Thus, managers can increase or decrease the result, in accordance with the purpose.

Another possibility to influence the result using the policies related to stocks is considering the possibility to include the borrowing costs in the cost of inventories under IAS 23 "Borrowing Costs"[IFRS, 2011, IAS 23].

For example, we start from the fact that an entity has acquired during the year N finished products at the production cost of 10,000 mu, it recorded expenses of 20,000 mu with the raw materials, expenses with salary and social contributions of 1,200,000 mu, other operating expenses in the amount of 8,000 lei and expenses with the interest of bank loans in the amount of 1,000 mu, and the turnover recorded was 57,000 mu. The result will be different depending on the entity's management decision to capitalize the interest expense or not.

The application of the mentioned accounting treatment has the following impact on the profit and loss account:

Extract from the profit and loss account

Elements	Interest is capitalized	Interest is not capitalized
Turnover	57,000	57,000
Variation of stocks	11,000	10,000
Expenses with raw materials	20,000	20,000
Salary and social expenses	12,000	12,000
Other operating expenses	8,000	8,000
Operating result	28,000	27,000
Expenses regarding the interest	-----	1,000
Accounting result	28,000	26,000

Including the interest expense in the cost of inventories distorts the real image of the entity, determining an increase of the result.

Creative accounting practices related to tangible assets are based on the accounting policies and treatments related to tangible assets and stipulated in IAS 16 "Tangible assets"[IFRS, 2011, IAS 16].

The standard provides that in case of expenses after commissioning an item of land and tangible nature that has already been recognized, they must be added to the accounting value of asset only when it is estimated that the entity will obtain supplementary future economic benefits compared to the performance originally expected as appropriate.

To exemplify we consider that an entity has initially renovated at the beginning of exercise N a building operating an administrative department. The building was purchased 18 years ago at an input value of 20,000,000 mu, and its useful life is 20 years. The renovation expenses were 1.6 million mu. The entity's management believes that the deterioration degree of the building is high, and its restoration is necessary to ensure a continuous functionality. The proposed solution is the non-capitalization of the renovation costs. If the entity's managers take into consideration the purchase of new headquarters and the sale of the existing one, they would choose the capitalization of the renovation costs. Having the turnover of 10,000,000 mu, costs with the raw materials of 2,000,000 mu, salary and social costs of 1,200,000 mu and other operating expenses of 800,000 mu, the income statement looks like this:

Extract from the profit and loss account

Elements	N		N+1	
	Renovation expenses		Renovation expenses	
	It is capitalized	It is not capitalized	It is capitalized	It is not capitalized
Turnover	10,000,000	10,000,000	10,000,000	10,000,000
Renovation expenses	-----	1,600,000	-----	-----
Depreciation expenses	1,800,000	1,000,000	1,800,000	1,000,000
Expenses with raw materials	2,000,000	2,000,000	2,000,000	2,000,000
Salary and social expenses	1,200,000	1,200,000	1,200,000	1,200,000
Other operating expenses	800,000	800,000	800,000	800,000
Impact on the result sheet	1,800,000	2,600,000	1,800,000	1,000,000
Accounting result	4,200,000	2,600,000	4,200,000	5,000,000

The capitalization of renovation expenses has the same impact both on the year N and on year N +1 and unlike the situation when they are not capitalized.

Related to depreciation, the regular method chosen for depreciation is the one which reflects the rate at which the future economic benefits are consumed due to the use of the respective asset. The entities have the possibility to choose between the different depreciation methods resulting in the many cases, to different results.

Regarding the revaluation of tangible assets we can say that many distressed entities make use of this accounting engineering construction, as an ultimate chance to improve the performance reflected in the statement of changes in equity.

To exemplify we suppose that an entity has an industrial building acquired at the value of 6,000,000 mu, where the depreciated value is 3,000,000 mu. The depreciation method used is linear and the remaining life is 10 years. The entity's management decides at the beginning of N to reassess the immobilization, the fair value being of 7,000,000 mu. Before reevaluation the equity situation was as follows: social capital 100,000,000 mu, revaluation reserves 8,000,000 mu. The entity's performance before and after revaluation as evidenced by the statement of changes in equity is:

Extract from statement of changes in equity

Elements	Before the revaluation	After the revaluation
Social capital	100,000,000	100,000,000
Revaluation reserve	8,000,000	12,000,000
Total equity	108,000,000	112,000,000

The revaluation of depreciable assets has influence on the result in that it has the effect of increasing the depreciation expenses. The annual depreciation before revaluation is 300,000 mu, and after revaluation is 700,000 mu ($7,000,000 \times 10\%$). Thus, the result is decreased by 400,000 mu, after revaluation (we maintain the data in the example on the previous page):

Extract from the profit and loss account for the year N

Elements	Before the reevaluation	After the reevaluation
Turnover	10,000,000	10,000,000
Depreciation expenses	300,000	700,000
Expenses with raw materials	2,000,000	2,000,000
Salary and social expenses	1,200,000	1,200,000
Other operating expenses	800,000	800,000
Accounting result	5,700,000	5,300,000

To counteract the decrease of the result, entities prefer to reassess depreciable assets.

To overcome the disadvantage of reducing result, entities may use the surplus value imputation from revaluation on revaluation reserves.

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