THE ROLE OF CREATIVE ACCOUNTING IN "STIMULATING" FINANCIAL PERFORMANCE

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***Abstract**: The financial performance of an economic entity is its business card vis-à-vis its stakeholders, on the basis of which they make their investment, credit or other type of collaboration decisions. Information reflecting the financial performance is most often represented by the level of income and expense, the level of profit, the balance sheet asset and other intermediate and relative indicators deriving from them. The issue we are debating in this paper derives from the fact that the aforementioned figures are easily influenced by creative accounting techniques, and the financial performance assessed on the basis of this information is thus misleading. In this context, this paper aims to present the negative effects of creative accounting, to exemplify some creative accounting techniques, and how these practices impinge on performance indicators, as well as to suggest ways to protect stakeholders against accounting manipulations.*

***Key words:** creative accounting, financial performance, accounting result, accounting options, stakeholders.*
***JEL Classification:** M40, M41.*

1. Introduction

Creative accounting is a current and controversial topic, a subject of interest to both professional accountants and users of financial-accounting information.

In an attempt to decipher this “Pandora's box”, as some authors have called creative accounting, opinions are among the most diverse. It is a fact that it distorts the quality of information, results and financial performance, managing to engage in its whirlwind less scrupulous managers, accountants, auditors, who, by doubtful means, seek to gain undue advantages.

Although it differentiates itself from accounting fraud by respecting the letter of the law, but not its spirit, this does not make creative creative accounting less dangerous. On the contrary, it makes it more misleading and harder to detect.

Also difficult is the battle against these practices as long as we cannot bet on the morality of those involved. Because creative accounting is a matter of ethics, of principles. It derives from the subjectivity inherent to the professional reasoning exerted in interpreting economic transactions, in establishing estimates, choosing accounting policies, subjectivity that can transform the fair view into a convenient one. The victims of this phenomenon are existing and potential investors, lenders and other creditors in the decisions they make on the basis of financial information. We draw their attention to the fact that in interpreting performance, they also turn their focus to the explanatory notes, to the cash flow statement, to a more detailed analysis of the published and available information.

2. Research Methodology

In the context in which creative accounting is seen as a problem, the subject should not be circumvented, but commented and deepened to delimit what is moral, what is immoral, the legal from the illegal, what is allowed from what is not allowed.

Approaching the subject in a positive way is far from our intentions, the purpose of the paper is not to provide ideas based on creative accounting practices in achieving the objectives of economic entities to the detriment of the interests of the users but to avert practitioners from the dangers to which they are subjected in such practices, and users of the negative implications of creative accounting on the quality of the information presented, on the financial performance, all the more so due to the fact that more than half of the professional accountants interviewed by Cernuşca and others (2016) would not shy away from using creative accounting practices as long as they do not violate the law.

The research methodology used for the elaboration of the paper refers only to qualitative methods. The review of the literature is complemented by a critical analysis and inductive and deductive reasoning based on accounting legislation and practice.

We have used relatively recent sources of information, but also older sources. The latter, however, have not lost their validity, being used to support certain ideas. In order to elaborate the paper, we consulted studies conducted by Romanian authors that personalize the phenomenon to our country, as well as an international bibliography to give a complex approach to it.

3. Aims, means and effects of creative accounting

Creative accounting is a highly controversial and debated issue over the past decades. Many authors who have debated the subject of creative accounting have attributed different definitions to highlight its main features. Trotman, quoted by Munteanu and Zuca (2011), defines creative accounting as "a communication technique aimed at improving information provided to investors" through practices that seek to "embellish the image of the financial situation and economic and financial performance". In this context, accounting becomes "the art of selling the economic performance of the enterprise" (Pigé and Paper, 2005).

The factors facilitating the use of creative accounting are related to "the existence of options, subjectivism and gaps in norms" (Tabără & Rusu, 2011).

The motivation for recourse to creative accounting is represented by the objectives envisaged by the economic entities. The attraction of funding, irrespective of its source, the banking market or the capital market, as well as the overcoming of competition are some of the objectives generating creative accounting reasoning.

In order to attract funding, creative accounting is an important tool that helps to embellish the image of financial position and economic and financial performance (Colasse, 1996) and to improve investor information through techniques capable of generating a favorable image and the illusion of financial results that are more attractive but not real (Trotman, 1993). "Improve" here acquires the meaning of "distorting" financial-accounting information. In other words, it is misleading the stakeholders about the company's economic performance and influencing decisions that depend on the numbers reported in accounting (Healey and Wahlen, 1999). All of these statements allude to the negative and perfidious side of creative accounting, about which Jameson (1988) has no doubt.

There are numerous points of view, among the most knowledged, that the profit is an indicator, if not the "main indicator of measuring the financial performance of the entity" (Chirilă, 2004; Tulvinschi, 2013; Petrescu, 2004/2005). Thus, the main direction of action to shape performance presented in the financial statements refers to the "production" of the desired accounting result (Naser, 1993, p.59). Maximizing profits can be an objective for large listed companies and the Anglo-Saxon accounting environment for attracting investors. For the same purpose, maintaining a balance from year to year may be desirable. Suppose, exceptionally, we are in a good year for the firm. Because for the following years there are no predictions comparable results to those of the current year, it is preferable that part of the result be passed over to the following years so that too much gaping from one year to another does not trigger an alarm and not produce a negative impact on the business. This strategy is known in the literature as profit / income / earnings smoothing. On the other hand, the minimization of the outcome can be considered for the purpose of reducing taxation.

There are also techniques that improve the company's liquidity or reduce costs or indebtedness (Groşanu, Răchişan and Berinde, 2012; Feleagă, 1999).

Last but not least, creative accounting is also manifested through the manipulation of the information presented in the explanatory notes to financial statements. There are parts in the explanatory notes where more or less information can be included. Lack of relevant information can hide poor performance, which can affect external users' decisions.

Among the effects that the use of creative accounting techniques can have on financial statements are (Tabără & Rusu, 2011):

- Changes in the value and structure of expenses and revenues and, implicitly, in the accounting result, and the effect is propagated in chain until the value and structure of the equity and all the calculated rates are changed;
- Changes in the value of current and non-current assets, as well as indicators calculated on the basis thereof.

In other words, creative accounting distorts the results and financial position of the enterprise and leads to the creation of an altered impression of business performance (Mulford and Comiskey, 2009).

4. Creative accounting techniques

Creative accounting makes use of "a mix of practices to the limit of legality" (Colasse, 1996). Romanian auditors who responded to a study by Balaciu and others (2012) asserts that the most common creative accounting practices relate to: recognition and measurement of provisions; amortization and depreciation of fixed assets; valuation of stocks, but the other practices suggested in the questionnaire were identified by Romanian auditors as being the object of creative accounting: development expenditures; revaluation of tangible assets; financial assets; recording revenue / expenses in advance as income / expense of the period. Other practices of maximizing or minimizing profit, as the case may be, from which we mention the registration of construction contracts.

We will show how the depreciation of fixed assets and the recognition of development costs affects the financial performance, explaining the impact that these options have on the accounting result, the treasury, and further on investors and other users.

Amortization of fixed assets

Accounting policies, options and estimates for depreciation of assets refer to:

- estimating residual value;
- depreciation method (linear, accelerated, degressive)
- estimation of the normal use time.

Linear depreciation has the effect of smoothing the results. This is why "listed companies prefer the linear depreciation of fixed assets" (Penno and Simon, 1986). In order to verify whether the claim is currently being verified and if it's verified in our country, we conducted a survey among listed companies on the regulated market of the Bucharest Stock Exchange. Thus, we consulted the financial statements and explanatory notes of 87 companies for the year 2017. Of the 87 companies observed, one does not own tangible assets, leaving 86 in the observed group, of which 78 apply the exclusively the linear method. The remainder of 8 also opt for linear depreciation, and for some of the fixed assets they apply the accelerated, degressive or depreciation method per product unit. This confirms the hypothesis of Penno and Simon.

Degressive depreciation is economically justified by the fact that for some fixed assets depreciation is higher in the first exercises than at the end of their life.

Accelerated depreciation proposes an aggressive approach, by which through aggressive treatment, we understand the treatment that leaves its mark on the variation of the result visible both in the direction of growth and in the sense of its decrease. 'As calculated depreciation has to be correlated with the use of the asset and, as there are rare situations when a corporeal asset is consumed in the first year by up to 50%, it follows that the accelerated depreciation method is less used for accounting purposes '(Man, Dima and Minea, 2011). We can therefore infer what the strategy of an entity that uses this depreciation method is - the reduction of the result, the taxable base, the tax on profit, in fact. Therefore, just as a measure of prevention for this kind of reasoning in the past, 'the use of the accelerated depreciation regime is approved by the Ministry of Finance at the proposal of the General Assembly of the Associates.' (Ristea et al, 1995).

The degressive method, and moreover the accelerated method, allows for tax savings in the early years.

Due to these variations between the effects of depreciation methods and the lifetime and residual value of property, plant and equipment that affect the entity's performance, some indicators that do not take into account depreciation, such as gross operating profit or EBITDA, are calculated.

Research and development expenditures

“The distinction between research spending and development spending creates prerequisites for the manifestation of accounting creativity. Thus, a company that uses a development capitalization policy may increase or decrease the result of an exercise by simply reclassifying the expenses in the research category, in which case the profit or loss account is affected or in the development category, in which case the balance sheet is affected. Additionally, the company may invoke at any time uncertainties about the completion of the project to offset the development expenses on the balance sheet in the profit and loss account. Moreover, some referentors allow a reactivation of these expenditures when the uncertainties disappear.” (Feleagă and Malciu, 2002)

The effects of the change in accounting policy on research / development expenditures on the outcome are highlighted by Smith (1992) who cites the example of British company Cray Electronics which in 1989 published a £ 17.03 million benefit. As a result of the review of accounting policies in R & D spending, by their full inclusion in the profit and loss account, the benefit of the exercise diminished to £ 1.33 million (Feleagă and Malciu, 2002).

To highlight the effect that recognition of expenditures as research or development spending has on user judgment and decision, McGee (quoted by Amat and Blake) has prepared financial information for two companies. In fact, the information was identical, with the only difference that one of the companies capitalized development costs and the other put them in the profit and loss account. The information was used in two ways (Feleagă and Malciu, 2002):

a) A sample of bank analysts were divided into two groups: the first group received the financial statements in the capitalization of development expenditures and the second group the financial statements in the case of the recording of the development expenses in the profit and loss account. Among the questions addressed to the two groups were the following: Would you give this company a credit line? If so, at what interest rate? Would you give this company a $ 2 million loan? If so, at what interest rate?

b) Another sample of bank analysts received both sets of financial statements. These analysts were asked to compare the two companies. Among the questions addressed to this group, we mention: Which of the two companies do you prefer? Would you like to give your company a $ 3,000,000 credit? What is the risk that this company will not repay the loan? The answers of the interviewed subjects are summarized in the following table.

Table 1. Banking analyst decisions on policy to capitalize development expenditures or write them down in current expenses

		Capitalized development expenditures	Development expenditures written in current expenses
Group 1	No credit line is provided	25%	57%
	Average interest rate	12,556%	12,974%
	A $ 2 million loan is granted	50%	30%
	Average interest rate for $ 2 million	13,165%	13,474%
Group 2	The preferred company	62,2%	11,1%
	A $ 3 million loan is granted	61,4%	27,3%
	Average default risk	23,5%	46,2%

Source: Feleagă and Malciu, 2002.

From the answers presented, it can be noticed that in the case of the capitalization of the development costs, the entity can get more advantages, its image among the creditors being better. From this example, it is clearly seen how banking analists, pertinent and experienced users, we can say, “are seduced by higher results” (Feleagă and Malciu, 2002), obtained only by choosing a more favorable accounting treatment. We can say that the limit of this study was the lack of explanatory notes, additional information, but the figures convey the first impression and are often the only information read.

The capitalization of development spending policy has effects on cash-flow. Thus, “companies capitalizing on the expenditures of developing software programs will report capitalized amounts as payments related to the investment activity and not to that of exploitation. Therefore, a company that capitalizes on a larger portion of costs will have a higher value of operating cash flow than companies that spend all the costs associated with software development (Ivan, 2015)”.

5. Protecting stakeholders’ interests

Before finding mediators of the conflict of interest that exists between management and other stakeholders, we draw the attention of the latter to the fact that the accounting result will not be identified with the cash and cash equivalents actually outstanding after the receipts and payments. It can even come to the fact that, despite the fact that the result is extremely attractive, the company can not handle payments, which means that a higher result will not guarantee higher dividends for shareholders, especially as it was forcibly obtained. Therefore, investors' attention should also be directed to the cash flow statement and liquidity ratios, and more importantly, we recommend comparing net cash flows with net profit to trace creative accounting by “non-generating cash expenses and income, as well as items of assets and liabilities that defer receipts and payments” (Ivan, 2015), but we do not have to make hasty conclusions because this difference occurs primarily on account of accrual accounting. However, comparing net cash flows with net profit “highlights the net profitability of generating cash” and determines the difference between “calculated and actual performance” (Achim and Borlea, 2012).

Howard Schilit (2003, p. 203) states in a study that by comparing cash flows with profit, we should get an alarm signal in the event of a large discrepancy. Reporting negative or small cash flows under a high operating result may generate suspicions about the quality of revenue and expenditure and may be a sign of the use of creative accounting. More specifically, "in order to detect the high incomes that do not bring cash, it is recommended to examine the relationship between cash flows from operating activities over a period and net income: if net income has a positive value, while treasury flows of the exploitation activity are negative, there is a likelihood of manipulation of the results by the leadership" (Ivan, 2015).

Audit has a vital role to play in supporting investors' interests. "The economic role of the audit is to reduce the risk of the investor" (Ionascu, 1997). Financial audit ensures the credibility of the financial statements. Audited information is more credible and more useful in the decision making process for key users - the investors. "An important role of the financial audit is to provide the public with confidence that the information disseminated in the financial statements corresponds to the reality of the reporting entities, in other words, they reflect a fair view of the entity's assets, liabilities, financial position, profit or loss (Toma, 2012)"**.**

Transparency requirements are a concretisation of the accounting information function. Improving this function is a major direction for action in accounting practice. Transparency practices are key elements in gaining investor confidence and have an essential contribution to the success of fundraising operations through the capital market.

6. Conclusions and suggestions

The presented techniques demonstrate the hypothesis that "accounting truth is not an absolute but rather a built one" (Firescu, 2014), especially when talking about the accounting result. The cash flow is a more objective indicator, so it is also recommended to study it in parallel with the operating result. An excessive discrepancy between these values may be a sign of creative accounting.

Creative accounting is, from the point of view of top managers, interested in the reputation of the company, a saving solution in situations where things do not go smoothly and is regarded as a negative aspect by those interested in the real performance of the company that can lose from creativity in accounting, because their decisions are based on attractive but unrealistic financial performance. We noticed in Chapter 2.2. that the bank analysts, informed users, let themselves be seduced by higher results. Creative accounting is therefore a skillful weapon used by managers in the conflict of interest that exists between them and other stakeholders, but the latter can use as a defense a more detailed analysis of performance, a more in-depth study of the explanatory notes, and last but not least, we put our trust in audit, corporate governance and transparency as ways of mediating conflict of interest.

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