DETECTION OF CREATIVE ACCOUNTING PRACTICES

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***Abstract**: This paper aims to describe the nature and causes of creative accounting by applying manipulative behavior to the preparation of financial statements and to explore the determinants that may encourage economic entities (EE) to mislead investors or shareholders throughout this process. A careful reading and analysis of the financial documents provided by the economic entities allows to observe and verify certain accounting data management operations. Recognition of revenue outside regulations, transfers of current expenses to future periods, overvalued assets and undervalued liabilities are the main transactions identified. By using these operations, professional accountants can modify the financial indicators of the economic entities. Measures that can be taken to combat or reduce these inappropriate practices are also analyzed.*

***Keywords**: creative accounting, financial performance, entrepreneurship, policies and regulation, audit.*

***JEL Classification**: M41, M42, M21.*

1. Introduction

The accounting environment has become much more complex with the advent of IFRS accounting standards, the accounting rules being more and more flexible, circumstances that allowed frequent financial manipulations with a view to presenting more advantageous financial statements.

Financial manipulation, named as "creative accounting" (CA) is not a simple practice performed by just any accountant professional. If it were, the omissions or tricks applied would be easy to detect. This is a practice that requires the application of complex methods or techniques, applied by creative professionals, with advanced knowledge of the accounting and legal regulations.

In order to satisfy the needs of users or stakeholders regarding financial information, the practice of so-called creative accounting arises to show, not what it is, but what it is wanted to be, manipulating and taking advantage of the gaps in the accounting and legal framework to achieve the aims or objectives pursued by carrying out such incorrect and undesirable practices.

Though detection techniques are increasingly gaining ground, financial manipulations remain very difficult to detect in due time, before they have produced their effects among interested parties. Financial manipulation has a major impact on the valuation of the economic entities that commits to such practices.

The paper is focused on presenting the main motives that are standing behind financial manipulation, as well as the most common techniques, and finally the measures that may be taken in order to minimize creative accounting practices.

2. The concept of creative accounting

For some authors, like Naser (1993), creative accounting is the process of manipulating accounting to take advantage of the gaps and inaccuracies of accounting standards, as well as the different approaches and presentation options contained therein, to manipulate and transform the financial statements from what they would normally show to who they want them to be. It also involves the process by which operations are adapted to obtain the desired accounting results, rather than reporting in a consistent and neutral way.

Other authors, namely Amat and Blake (1999), indicate that creative accounting consists of accounting professionals manipulating financial information using their knowledge by taking advantage of the gaps and omissions of the existing regulations, and of the optionality between different valuation practices that this offers.

Generally, the authors agree that creative accounting is the use of flexibility, subjectivity and gaps in accounting and legal regulations to manipulate and apply incorrect and, many times, negative practices, the only thing they cause is distortion in the presentation of reasonable, reliable and impartial financial information.

This is intended to show the preferred result, rather than the real and reasonable one. In this way, the financial information of economic entities changes, benefiting or fulfilling the particular objectives of managers or shareholders, pursued when applying them.

From the creativity used in the procedures applied to manipulate financial information some questions may arise, whether the techniques used are in line with legal normative or not. The answer is always related to a fine line that separates them, which is increasingly difficult to identify.

3. Causes and factors of creative accounting

Creative accounting practice, so debated and questioned, arises because of the intention of those responsible for adopting accounting practices, being free to use one or another accounting policy. The causes are related to accounting regulations, their gaps, subjectivities, and presentation options, as well as the legal framework that may be particular for each country.

The need for the economic entities to show the desired level of results to those interested, whether they are managers, professional accountants or shareholders, has made it possible to achieving the level of satisfaction through the use of negative and deceptive practices. The phenomenon has become common throughout the world, and with a view to growing more and more in today's globalized economic environment.

Main users of creative accounting are the managers, who are responsible for making decisions about accounting policies. These decisions are influenced by the results that they want to reflect to the shareholders or interested parties.

Detecting creative accounting practices raises challenges as they are hidden behind complicated accounting operations. Not being easily to uncover and react timely, the use of creative accounting is becoming an abuse of these practices and is increasing rapidly. Thus, the accounting statements published by the economic entities are losing reasonable neutrality, impartiality and reliability, aspects that interested users require for effective decision making.

Some of the reasons behind the decision to engage in manipulating financial statements, in order to achieve these objectives, are mentioned below:

- management remuneration linked to benefits and shares allocation;
- accessing financial resources from credit institutions;
- results improvement to cover a difficult period with unfavorable results;
- management results recognition and consolidation of their position within the economy entity;
- presenting an improved financial result to investors in order to gain their confidence;
- meet market expectation.

The incentives to carry out practices that may determine the management to engage in financial manipulation are determined by several factors, among them being the following, categorized as below (figure 1):

Figure 1. Factors to engage in creative accounting
Sources: elaborated by the author

Several factors, among those mentioned above, are linked to financial markets. In this context, it is useful to remember that, in traditional accounting literature, earnings smoothing improves shareholders wealth, since it reduces the uncertainty of future cash flows. The accounting smoothing of results appears to be an unreasonable behaviour. However, signal theory and agency theory offer some explanations for outcome smoothing behaviour that are not at odds with investor rationality (Chalayer, 1995).

Given the circumstances of these developments, the creative accounting may be defined as a set of procedures aimed at modifying the level of income, for the sake of optimization or minimization, or the presentation of financial statements without these objectives being mutually excluded.

The procedures implemented are based on the choices offered by the accounting regulations as well as on the possibilities opened up by the weaknesses and deficiencies of the accounting texts or even on the differences between the international rules and those of a specific country, but also on arrangements for which accounting can intervene according to two opposing schemes: determining the accounting translation of a legal-financial transaction or drawing up a legal-financial arrangement with the aim of modifying the result or the financial statements.

4. Measures to combat the use of creative accounting

Creative accounting has a strong impact on financial information and, therefore, on the decisions that interested users or stakeholders make based on it. In fact, when users use financial information, they do so to support the decision-making process.

In case the information presented by the economic entities is the result of the application of creative practices, it, without a doubt, deviate the true image of the economic entity, thus, the decisions made by stakeholders or interested users will be affected in a negative way for being based on data that is not real or reasonable.

Therefore, the use of creative practices has a negative impact on financial information, insofar as it generates a loss of the reasonable security that is required and prevents neutral transactions from being represented. At the same time, it poses a significant threat to the integrity of the annual accounts when affects the information presented to users who use such information. In addition, it prevents the true faithful image of the economic entity from being reflected, which is the one that must be put before everything.

In order to eliminate the use of creative accounting, steps must be taken to reduce it to the minimum and thus gradually eliminate it. For this, it is necessary to adopt measures that act against the factors and causes that facilitate and allow its application and use, as the various competent authorities specializing in the matter have been proposing.

Regarding the causes that facilitate creative accounting, the following ones may be highlighted:

- enhance the accounting rules, in the sense of giving a reduced level of optionality for the economic entities from which they can choose;
- establish a more detailed and concise accounting regulations, while the criteria to be applied is precisely established, hindering this the options of creativity;
- increase the requirements in terms of quality and in depthness of financial information provided by an economic entity;
- create a control mechanism to work as an obstacle in front of manipulative behavior, mechanism that may be implemented as below described (figure 2):

Figure 2. Control mechanism of creative accounting

Sources: elaborated by the author

The internal control that can be exercised within the economic entity may work as a limitation for creative accounting, since the use and application of sanctions to those who engage in it can significantly reduce its dissemination of false information and may serve as an impediment to manipulation.

The use of creative accounting may turn at some point against the economic entity, since, if the use of unethical practices is detected by external users, the economic entity would receive significant penalties from them.

Limiting creative accounting practices is a must considering its linkage to scandals due to fraud, corruption, conflicts of interest and professional malpractice, who infringes codes of ethics by deceiving partners, employees and external interested parties.

According to Cordobés and Molina (2000), in order to avoid creative accounting practices, the financial statements should compulsorily contain all those data for which reality is not reached, and provide information on each and every one of the criteria taken into account to arrive to the situation that is presented.

To reduce the possibility for creative accounting to produce its effects, accounting regulations should narrow the scope of estimates, as presented below (figure 3).

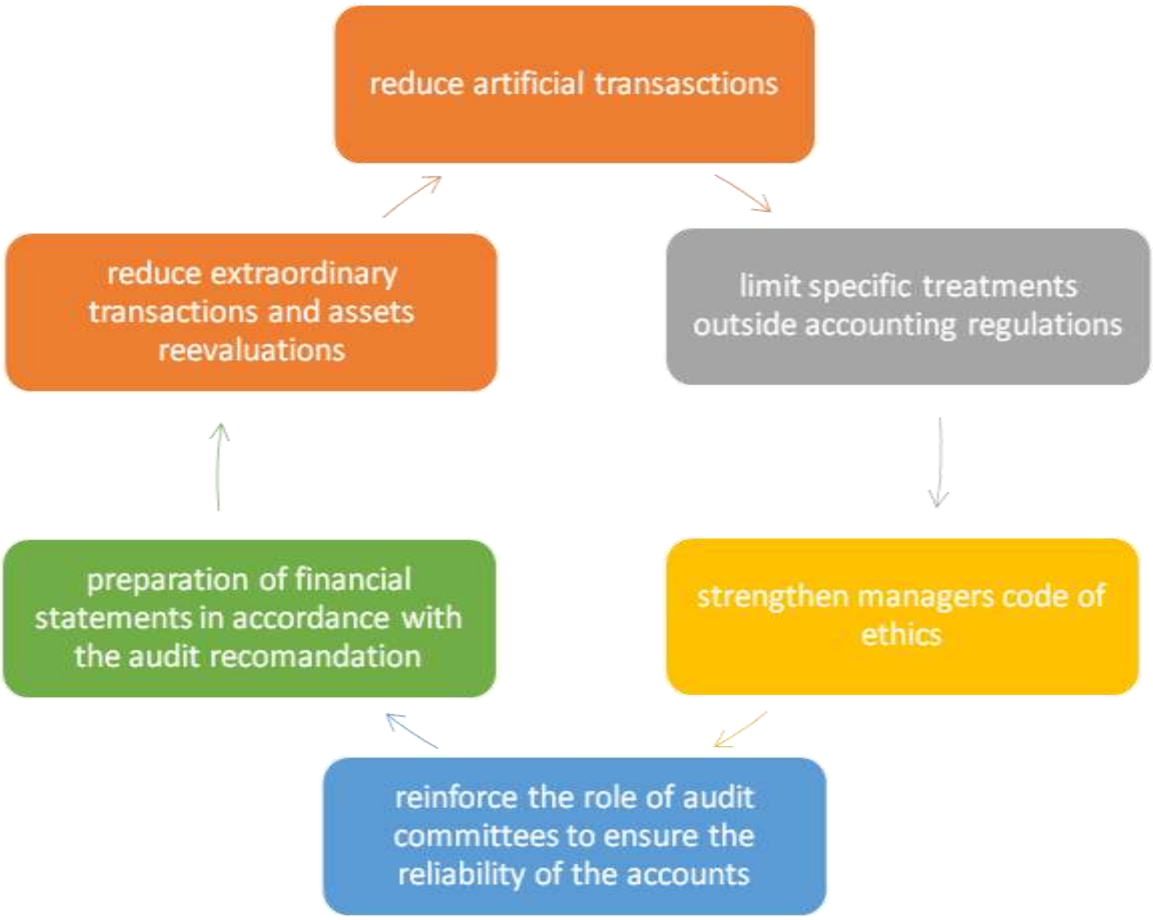

Figure 3. Regulations enhancement to avoid creative accounting

Sources: elaborated by the author

5. Conclusions

The management of accounting data leading to the publication of improved financial statements, whether it involves manipulation or fraud, is more easily hidden in a globalized economic environment. The use of creative accounting holds different opinions, but is generally agreed that the detrimental effect it has on an economic entity cannot be denied.

The strong growth of entrepreneurship initiative, the changes in accounting regulations, but also the recent negative experiences caused by the economic crisis, with moderate forecasts regarding the economic evolution for the next period, represent factors favorable to the management of accounting data within economic entities, regardless of their size.

Although creative accounting may be a solution for some challenges occurred during a business existence, it stands only as a short-term solution and it will eventually lead to harming the economic entity, as well as the managers, owners or related interested parties on the long term, including to the point of bankruptcy and liquidation.

The use of creative accounting is in fact the fault of all stakeholders, namely: users, for putting pressure on financial information; managers, for trying to achieve objectives and receive incentives: shareholders, for succumbing to manipulation in order to show users what they want to see; the auditors, for not remaining independent and falling before the benefits they would obtain from agreeing to keep creative practices hidden.

By deforming the judgment of the interested parties of financial statements, accounting manipulation undermines the efficiency of economic relations, jeopardizing the proper allocation of financial resources.

Despite the fact that some professional accountants agree on its use, underlining the positive implications, the fact that the techniques specific to creative accounting can be used at their own convenience, even outside of the law and regulations, it is self-understood that these practices need to be eradicated.

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