CREATIVE ACCOUNTING AND FRAUD: A COMPARATIVE APPROACH

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Abstract

The famous scandals of the past few years, the collapse of Enron, Parmalat, Xerox, WorldCom, have highlighted the creative manifestations of accountants. These manifestations, on the limit of legality, or, more severely, outside of it, have seriously affected the way in which, on a side, the profession and its accountability were to be seen in the future, and, on the other side, the activity of the companies. Even if it is considered that we have overcome the financial crisis, the business world is still a risky one, a real jungle where the strongest survives. In order to win in the „struggle for survival", the accountants were and are still using in some cases creative or fraudulent techniques. The concepts to which these techniques refer (creative accounting or fraud) are often considered synonymous in practice. In this paper we aim to present the characteristics, and to identify both the common points and the differences between the two.

Keywords: c*reative accounting, financial fraud, financial statements, financial reporting financial scandals*

JEL Classification: M21, M41, M42

1. Introduction

The bankruptcies of Enron, Parmalat, Xerox, WorldCom have highlighted the creative manifestations of accountants. These manifestations on the limit of legality, or more severely outside of it, materialized in not qualitative financial reporting which has seriously affected the way in which, on a side, the profession and its accountability were to be seen in the future, and, on the other side, the activity of the companies. The purpose of financial reporting is to present useful information for economic decision-making process, for a wide range of users, (such as owners, shareholders, associates, potential investors on a side and, on the other side creditors and other lenders). The affecting of the process of financial reporting through creative or fraudulent techniques lead to an influence on decisions and implicitly to a decrease in the trust of people involved in the decision-making process. The concepts these techniques are referring to (creative accounting or fraud) are often considered synonymous in practice. By analyzing the characteristics of the two, we seek to identify both the common points and the differences between them.

2. Conceptual approach of fraud

The word fraud is perceived in the literature as a technical term used to briefly express a complex situation that is analyzed according to certain professional criteria that, at least at a quick assessment, have been violated (Dinica 2017). Fraud (according to the explanatory dictionary of the Romanian language) is the *act of acting in bad faith, in order to obtain benefits, for the attainment of the rights of another (damaging implied to another person)*. In the business world, fraud refers to an intentional act of one or more persons entrusted with conducting a company or working in it, involving the use of deception to obtain unfair advantages (Horomnea 2009). Usually, fraud is presented from the perspective of those responsible for discovering these techniques: financial auditors. Auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements. The AICPA (Association of International Certified Professional Accountants), by the instrumentality of SAS 99 and SAS 113(Statements of Audit Standards), states that the primary factor that

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distinguishes fraud from error is whether the underlying action is intentional or unintentional and defines fraud as an *intentional act that results in a material misstatement in financial statements that are the subject of an audit* (AICPA 2002).

IFAC trough International Standard on Auditing ISA 240 define it as „*an intentional act committed by one or more individuals within the management, personnel responsible for employee governance or third parties, involving the use of deception to obtain an unfair or illegal advantage"*(IFAC 2009), explaining also that the distinguishing factor between fraud and error is the intentional or unintentional character.

Based on the common elements of these definitions, we can say that fraud is an abstract concept, associated with a set of elements, events, processes, facts, and actions, influenced in bad faith, once or repeatedly, so that a consequence or all of the results violate one or all of the assessment criteria, regardless of whether damages or benefits of any kind are discovered (Dinica 2017).

There are multiple forms of fraud in a company. In fact, we cannot have a realistic view on the number of acts of fraud and their impact, as most of them are not advertised, being internally managed as each firm decides. Among the most popular forms found in the literature, we find: tax fraud, financial fraud, cyber fraud and insurance fraud.

Seen as a virus, financial fraud can take on various forms, ranging from the mere robbery committed by an employee to the large-scale cases that shook the world economy (Robu 2014). There are two major types of financial fraud: *fraudulent financial reporting* and *misappropriation of assets*.

Techniques to reach *fraudulent reporting* can take the form of:

- the falsifications and alterations of documents;
- the erroneous application of the criteria for recognizing and measurement of the elements of financial statements with direct implications on the financial position and performance, reflected in the reporting documents;
- misrepresentation of transactions or their intentional omission, with a direct impact on the contents of the list of journal entries;
- misapplication of accounting principles. In this case, we emphasize the reluctance of the managers and other persons responsible with the management of an entity on declaring disruptions in the going-concern concept, with a direct impact on the application of all the other principles;
- the accounting manipulations in the form of intentional mistakes and misrepresentations in the financial statements (which are intended to mislead or/and to influence users` decisions). Given that we have already referred to the presentation of financial position and performance, we are currently drawing attention to the application of materiality concept, with direct implications on the relevance of the information to be presented. Companies may decide not to provide timely and relevant information by setting a material threshold too high.

The *misappropriation of assets* mainly involves:

- taking assets from the entity without permission (especially for small and seemingly insignificant assets that can be easily stolen by employees of a company);
- the transfer of revenues into personal accounts;
- the use of the assets of an enterprise for personal purposes (for example, the use of a company asset for the purpose of securing a loan for personal purposes).

The factors that lead to fraud in accounting can be identified in the following situations:

- internal and external control systems are inefficient;
- investors' attention to the results of the company in most cases exerts pressure on those responsible for their management;
- poor internal audit;

- a reduced culture of sanctions regarding the inefficiency of internal control and audit systems.

There are three major categories of factors underlying fraud, presented in figure no. 1, structured in what literature calls the „triangle of fraud”: the *opportunity*, the *pressure* and the *rationalization*. Each angle materializes in a motivation to commit fraud (Robu 2014).

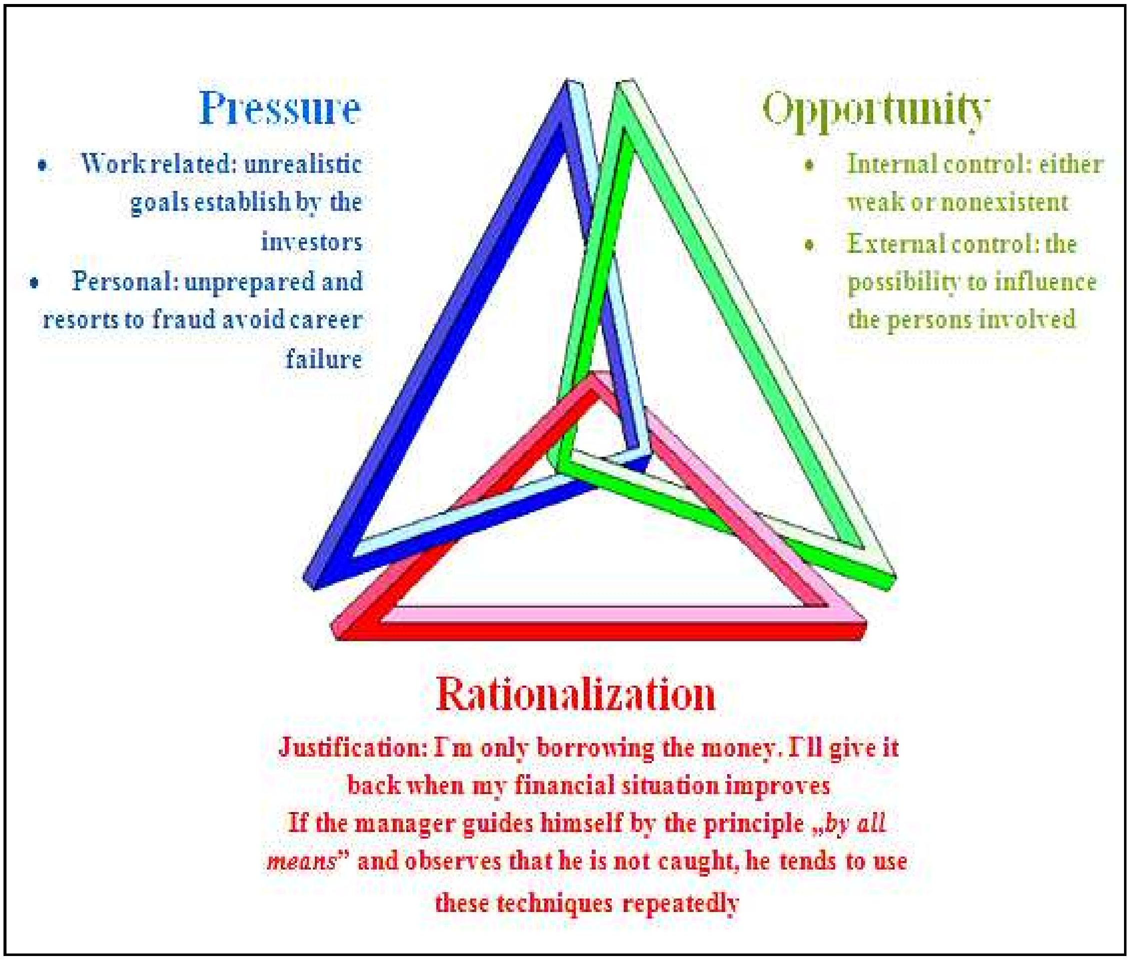

Figure no.1. The fraud triangle

Source: own processing after (Linker n.d.) available at http://blog.stephenlinker.com/tag/why-people-commit-fraud/

First, fraud involves *pressure* from investors (who are interested in business performance and sometimes impose unrealistic goals), from the economic environment and, last but not least, from the industry. The pressure of personal failure can also be taken into account when the person in charge of a particular task is unprepared and resorts to fraudulent techniques to avoid career failure.

Subsequently, the knowledge of the business environment, the breaches of the internal control and audit systems, the knowledge of the external control system or the possibility to influence the persons involved in carrying out these controls materialize in the *opportunity* for fraud.

Last but not least, the attitudes, the behavior, the reasoning of a professional hold a great influence on using fraudulent techniques. An individualist behavior will cause a manager to believe that the business belongs to him and will therefore justify his actions, thus avoiding being trapped. If the manager guides himself by the principle „*by all means*” and observes that he is not caught, he tends to use these techniques repeatedly.

Fraud involves pressure and opportunity, on the one hand, and incentives, on the other. Unfortunately, this means that many organizations and individuals will continue to face difficulties that can materialize in pressure, opportunity and rationality in committing fraud (Ciubotariu 2010).

3. Conceptual Approaches to Creative Accounting

In the literature, creative accounting is said to be a deceptive practice, as it tends to lead users to make decisions based on manipulated accounting information and can be understood as an intention to hide something, whenever no additional explanatory information is provided (Cosenza 2002). Over the years, creative accounting has been widely debated in both international and national accounting practice, being considered a matter of great interest, which raises questions about the degree of compliance between accounting and auditing objectives (Amat & Oliveras 2004). The definition of this concept proves to be quite complicated: a multitude of interpretations and no clear and unanimous definition (Ciocan 2017). With Anglo-Saxon origin, this concept has evolved in both the use and the used expressions. It is known in the literature under names like „income smoothing”, „earnings smoothing”, „cosmetic accounting” or „accounting cosmetics”, „financial engineering”, „earnings management” being preferred in the United States and „creative accounting” in European countries.

Defining the concept of „creative accounting” may seem, at first sight, an extremely simple matter. The reality is different. Being seen as a nowadays topic in the literature, an actual phenomenon that has been mainly shaped by large-scale scandals such as Enron, Parmalat, or Andersen, creative accounting does not have a single definition. Many authors have built definitions to explain this concept, being described as:

- *a process by which the management of an enterprise takes advantage of the shortcomings or uses the blurs in the accounting rules to present a modified image of the results* (Shah 1998);
- a *transformation of annual accounts using the accounting options, estimates or other practices accepted by accounting regulations* (Amat & Gowthorpe 2004);
- *deliberate diminution of fluctuations in the level of earnings considered normal for an enterprise* (Barnea et al. 1976);
- *action taken by a company's management, that affects the reported earnings and does not provide an economic advantage to the organization, but may prove to be harmful in the long term* (Merchant & Rockness 1994);
- *a set of procedures used to modify the level of results (to optimize or minimize them), or to present financial statements without these goals being mutually exclusive* (Stolowy 2000).

  The most complete, comprehensive definition belongs to Kamal Naser who considers creative accounting:
- *the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practices, in order to transform financial statements from what they should be, to what managers want them to express;*
- *the process by which transactions are structured, to produce the required accounting results rather than reflecting transactions in a neutral and consistent way* (Naser 1993).

Quoted in Riahi-Bealkoi (2004), Meehan states that the use of creative accounting practices usually occurs during certain periods: when the managers of a company are changed (the new leadership is tempted to use this technique to demonstrate improvement of results in the years to come), when a company registers an extraordinary gain, for which they are tempted to record expenses to hide this gain, and in times when earnings are weak, and management finds it appropriate to add additional expenses which normally belong to a future period.

If we have established up to this point which are the reasons invoked by practitioners for their creative accounting option, we also need to establish the typology of the creative accounting techniques. Which are the specifics of these techniques? Amat and Gowthorpe (2004) showed that the potential to use creative accounting techniques is found in six areas:

- regulatory flexibility (accounting regulations often allow the choice for a specific accounting policy);
- lack of regulation (there are transactions that are not fully regulated from accounting's point of view);
- managing opportunities for future prospects (which may occur in the case of estimates, and predictions), the timing of certain transactions (certain transactions can be programmed to lead to a desired image of the financial statements);
- use of artificial transactions (to manipulate balance sheets or to move the profit in another period, some transactions are used in relation to a third party, usually a bank);
- reclassification and presentation of financial information.

Ionascu (2003) classifies the creative accounting techniques in three main categories:

- techniques that affect the result (they influence elements in the profit and loss account). Many accountants are focused on organizing the company's income to deliver market-friendly signals to potential investors. For them and for the existing ones, a high profit at the end of the period indicates business performance and management's ability to lead. Sometimes the signals are wanted to be negative, not to attract the attention of public authorities, in search of funds for different activities. The most common technique applied to the income is to smooth it to create the illusion of financial stability in the eyes of investors.
- techniques with impact on the balance sheet (it influences its elements: assets, liabilities, equity). The handling of balance sheet items may be in response to the conditions imposed by various creditors that may ask for a certain level on indebtedness, liquidity or solvency ratios. It may also seek to offset some elements that create a less favorable image of the entity (a case that might be considered here is to ignore provisions and treat them as contingent liabilities, even when the risk of producing the event is high).
- techniques that influence the information presented in the appendix. By setting a high materiality threshold, professionals try to camouflage or selectively present certain situations.

According to Breton & Stolowy (2008), the techniques of manipulation through creativity are known in the form of:

- *big bath* - refers to the drastic reduction of profits in a period in order to cause their growth in a future period;
- *earnings management* - assumes obtaining a desired level of earnings for an enterprise;
- *income smoothing* - minimizes earnings variation from one period to another;
- *window dressing* - seeks to obtain the desired financial reporting.

The authors consider these techniques quite similar, in particular „earnings management", „income smoothing" and „big bath" accounting, which in some way target the manipulation of the income of a company. The demarcation line between these three methods is a very fine one: many authors regard income-smoothing as a component of „earnings management", and Breton states that „earnings management", in case of change of management, is actually „big bath".

4. Similarities and differences between creative accounting and financial fraud

The common element of the two concepts can be considered creativity. Whether we are talking about fraud or creative accounting, we must keep in mind that both involve a degree of inventiveness, innovation from the professionals. Manipulating financial results is also a common point between the two. When we are talking about creative accounting techniques (eg, misestimation of provisions, anticipated revenue recognition) or fraudulent techniques (eg, registering fictitious sales or underestimating the expense of a period), all of these lead to the alteration of financial accounting information and the misrepresentation of the economic reality. Whether it is legal, based on legislative gaps or illegal, the alteration of financial accounting information surely leads to change of reality and implicitly to different decisions.

The most important difference that can be systematized is related to the character of these techniques. As it can be seen from the definitions, creative accounting is considered a legal practice, located in the gray area of the accounting profession. Instead, fraud is knowingly breaking the law in order to get benefits from the presented situation. Creative accounting does not infringe the law. Bottom line, because it is considered to be positioned in the gray area of the accounting profession, creative accounting is distinguished from fraud by intent.

Using existing accounting options and the ability to interpret laws, manipulation of financial information through creative accounting is more likely to be a violation of the profession's ethics. It cannot be compared with infraction of ethics in the field of medicine, for example, but it must be borne in mind that the manipulation of financial accounting information can ultimately lead to the destruction of an entity and implicitly to the ruin of social status of the actors involved in the process. If we look at the case of the Anderson audit firm that was considered a credibility guarantor for Enron, we must bear in mind that the breach of the ethics code of the audit profession meant not only the collapse of the business but also the loss of the reputation for those involved in this action.

Conclusions

In the struggle for combating this phenomenon, the knowledge of fraud (its origin, influence factors and functioning mechanism, the profile of the fraudster and of the person to whom the act was committed) must be taken into account.

Extensive scandals highlighted the fact that society penalizes these manifestations. One of the differences that can be synthesized between creative accounting and fraud is related to those who can penalize these manifestations. If we consider creative accounting, it can be perceived more as a violation of ethics than law (creative accounting violates the spirit of the law, not its word), while fraud is a gross violation of legal regulations governing the business world. The sanction of creative accounting practices comes mainly from users directly involved in running a company (leading to lower confidence). Instead, fraud is prosecuted and sanctioned under the law.

For the business world, the main challenge remains to compute in numbers the influence that creative techniques have on the financial position and performance. Thus, although there are plenty of scientific papers that cover the problem of creative accounting versus fraud, we consider as necessary more quantitative approaches on the field.

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