

# The Impact of Creative Accounting of Frozen Assets on the Company Performance

Victoria FIRESCU<sup>1</sup>, Jenica POPESCU<sup>2</sup>

<sup>1</sup>University of Pitești

<sup>2</sup>University of Craiova

firescuvictoria@yahoo.com, jenica\_popescu@yahoo.com

**Abstract:** *The objective of our research is to highlight the concept, and especially the practices of the creative accounting or frozen assets and their implications for the company performance. More specifically, the practices and techniques of the creative accounting or frozen assets aim at assessing inherent risks related to the quality of the accounting information concerning company performance. The flexibility in the accounting normalization also takes into account the reality according to which the accounting truth is not an “absolute” truth in reflecting reality but rather a “built” truth.*

**Keywords:** recognition, assessment, amortisation, impairment, result, subsequent expenses

**JEL Classification:** M4, G3

## 1. Introduction

In most cases, in the field of finance and accounting, there are at least two solutions to solve a problem of the social and economic context. But each and every solution can have a different effect in the reflection of the financial position and of the performance of the company.

Over time, accounting was treated as an art: “the art of calculating profits”; “the art of presenting a balance sheet”; “the art of creating provisions”.

Regardless of the name it bears, accounting engineering or creative accounting refers to accounting practices deriving from standard accounting practices. They are characterised by excessive complications and a creativeness similar to writing a novel, with the purpose of presenting a favourable financial position and performance of the company. The financial statements thus obtained are not at all boring, on the contrary, they have the entire complexity of a novel, hence the name “creative” or “innovative”.

Accountants are faced with new forms of manifestation of the identity of the companies that are in a permanent competition, they must find quick solutions to adapt to the new information requirements, sometimes without waiting for the normalization, thus requiring creativeness in finding solutions and treatments that should be in favour of the image of the company and obtain an advantage, without coming in conflict with the law.

The existence of incertitude, both at economic and accounting level, in which the company operates leads to the fact that many items of the financial statements cannot be accurately measured, but only estimated.

The possibility to deliberately choose the option of company management for one of the many treatments and accounting policies creates a distortion of the quality of the financial information, generating uncertainties related to the consistence and comparability of the information dedicated to user, in which case we deal with an accounting of intent, in other words, we enter the area of creative accounting.

The fair image of the company involves presenting accounts prepared in compliance with the generally accepted accounting principles, the use of figures as accurate as possible, making assessments as reasonable as possible and organizing them in such a way as to be able to supply, despite all the limitations of the current accounting practices, the most objective image, without significant errors, distortions, manipulations or omissions. In other words, both the letter and the spirit of the law must be taken into account.

We believe that the references to “assessments as reasonable as possible” and to the limitations of the current accounting practices involve a certain tolerance to certain unavoidable inaccuracies. In other words, it is preferable to approximate than to rather than precisely wrong” (a thinking belonging to J. M. Keynes)

## **2. Research methodology**

In the specialized literature there is no consensus concerning the definition of the concept of creative accounting. A review of some of the most argued points of view related to the dimensions and limitations of creative accounting is attempted in this study. For this purpose, the research took into account, on the one hand, a systematisation and reconsideration, and on the other hand, a synthesis and a n antithesis of the ideas found concerning this topic in the specialised literature, in the regulations prepared by various professional bodies and by national and international regulatory authorities. In order to achieve the proposed desiderata we used a constructive-deductive and inductive methodology, in order to identify the opportunities for the creative accounting. A special emphasis was placed on the detection of motivations concerning the use of creative accounting and in this context, on identifying creative accounting practices and especially on the possibilities to limit them.

The positive part of creative accounting, or the creativity in accounting, refers to the application of the best options, the ultimate purpose being that the financial information in the financial statements reflects the fair image of the financial position, the performance of the company, and the change in the financial position.

## **3. Controversies regarding the definition of creative accounting in the context of the influence factors and of the options for a certain accounting policy**

Trotman (1993, page175) defines creative accounting as a communication technique aimed at improving the information provided to investors.

Colasse (1995) believes that the phrase “*creative accounting*” designates “accounting information practices, often at the limit of legality, used by certain companies which, taking advantage of the limits of normalization, aim at embellishing the image of their financial situation and of the economic and financial performance”. In another approach, Shah (1988) defines creative accounting as being the process by which management takes advantage of certain gaps or ambiguities in accounting standards to present a biased picture of financial performance. On the other hand, creative accounting can be defined as a set of methods aiming at either changing the level of the result, in order to maximize or minimize it, or at presenting the financial statements, while these two are not mutually exclusive. The accounting options have always been available to the accountant and they do not imply creativeness in the strictly negative meaning of the word.

One of the most complete definition of the notion of creative accounting was given by Naser (1993):

The process by which, given the existence of certain gaps in the rules, the accounting figures are manipulated and, taking advantage of the flexibility, the measurement and disclosure practices that are chosen are those that allow the transformation of the summary documents from what they should be into what the managers want;

The process by which the transactions are structured in such a way as to allow the “production” of the desired accounting result.

Malciu (1999) believes that most scholars accept however that, essentially, creative accounting is characterised by two aspects:

- it involves using the imagination of professional accountants in order to translate those legal, economic and financial innovations for which there is no normalized accounting solution at the time of their occurrence;
- the application of specific creative accounting techniques that are initiated depending on their incidence on the financial position and economic and financial performance of the entities.

Not all authors automatically believe that creative accounting is a negative thing. For example, in the opinion expressed by Malciu L., creative accounting has means that allow for keeping the pace with the increasing development of markets and the proliferation of financial products.

In our opinion, creative accounting is the result of the flexibility that exists in the accounting regulations and that, if they are applied in good faith, allow for providing as fair image of the financial position and performance of business entities.

However, each user of the accounting information has certain needs, certain interests and many times, the flexibility provided by accounting reference bases is used to satisfy private interests to the detriment of the public interest. Anyway, the application in good faith of the accounting standards does not ensure in an absolute way the satisfaction at the same level of the interests of all categories of users of the accounting information (investors, financial or commercial creditors, customers, employees, etc.). In our opinion, the order in which the categories of users of the accounting information are presented in the international regulations is not random, as the investors have priority over the others users.

Analysing the two accounting systems (the continental European and the Anglo-Saxon one), we can say that the more prescriptive and inflexible approach of the continental European model makes it easier to reduce the area of abusive choice of accounting policies and the manipulation of accounting assessments, while the Anglo-Saxon model leads more to the use of revaluation and the prevalence of substance over form.

**Table 1. Main factors leading to creative accounting**

It. no.	Factors	Explanations
1.	<b>Taxation</b>	In order to decrease his obligations to the state the entrepreneur uses techniques that will help him obtain lower financial results than the real ones, in order to pay reduced taxes.
2.	<b>Variety of the economic activities</b>	The variety of the activities in the economic environment requires a certain flexibility, which implies the existence of a range of options needed to capture and reflect the image of a certain activity.

It. no.	Factors	Explanations
3.	<b>The liberty of assessment, the possible options and alternatives available to the accountant</b>	Where law provisions do not offer clear solutions for a certain situation, for a certain situation, professional judgement is allowed to act, in compliance with the accounting standards and principles.
4.	<b>Government subsidies and grants</b>	In order to be able to receive such amounts of money, which do not bear costs, the company will model the accounting reality in such a way as to meet the criteria and achieve the required indicators.
5.	<b>The desire to enter the stock market</b>	The organizations interested to be listed at the stock market will resort to creative techniques and procedures that will allow them to obtain the results required to obtain access to such stock market.
6.	<b>Manager payment programme</b>	When the salary plan is set according to the performance recorded by the organization they manage, managers will be tempted to model the results obtained in such a way as to obtain more consistent salaries and bonuses.
7.	<b>Low competence of the managers</b>	In relation to the reasons why managers resort to creative accounting, we will bring into discussion their incompetence and lack of professionalism in managing a business.
8.	<b>Crisis periods</b>	The lack of own funds and the financing needs are a major factor that determines the use of creative accounting
9.	<b>Uncertainty and lack of confidence</b>	The manager's lack of confidence that he will attract an investment based on the real situation will determine him to embellish the information in the financial statements preventively.
10.	<b>The desire of self-assertion of young professionals</b>	At the beginning of a career, the ingenious and creative mind of young people will seek favourable solutions for the company, meant to ensure appreciation, advancement and remuneration according to the performance recorded.
11.	<b>Pressure exercised on professional accountants</b>	This category refers to the requirements imposed by managers on professional accountants and to the pressures exercised on them to reflect a "certain accounting truth" in the financial

It. no.	Factors	Explanations
		statements', which is consistent with the interests of the company.
12.	<b>The interest of the users of financial information directed especially towards the size of the return obtained by a company</b>	Creative accounting is preponderantly manifested on the elements in which the users of financial information are particularly interested.

By using creative accounting practices, companies can change the image related to the performance obtained.

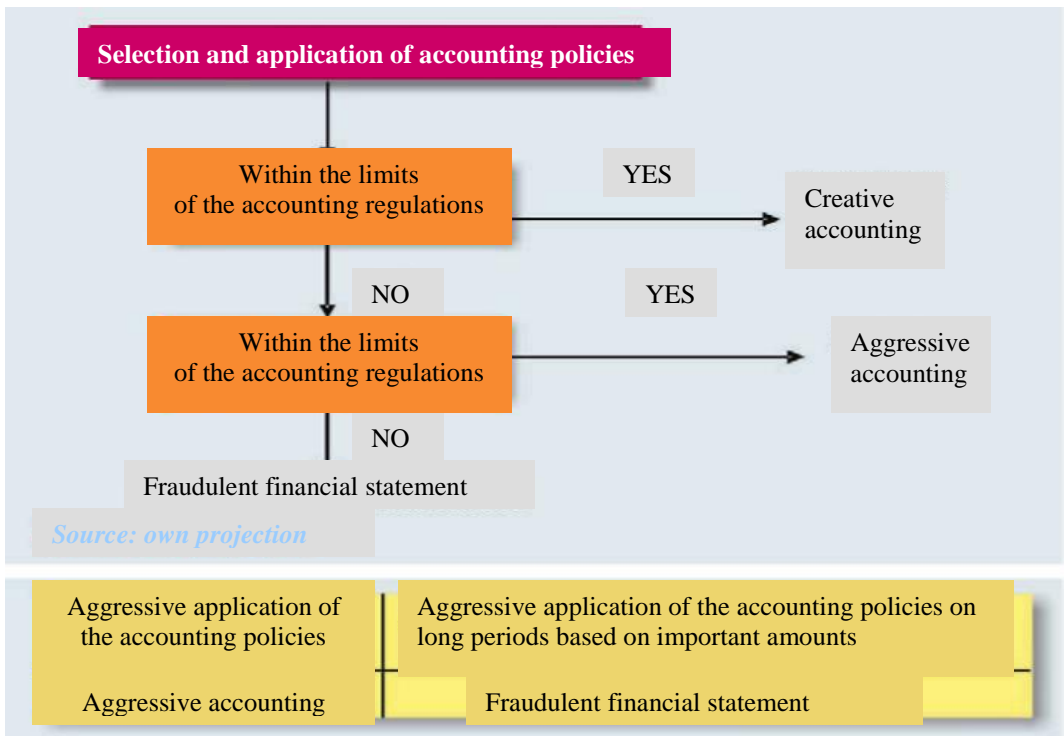


Figure 1. Choosing accounting practices

#### 4. Creative practices applied to tangible frozen assets with an impact on the return of the business entity

✎ *Recognizing and recording the impairment of the frozen assets within the context of the regulated accounting standards*

IAS 36 "Impairment of assets" requires that, at the date of each balance sheet, it should be determined whether there are indications that an analysed asset has undergone impairment. A subjective management deems that there are no indications of impairment of the asset, thus avoiding the decrease of the return with a potential impairment expense. Nevertheless, if it is deemed that the recoverable value is lower than the net book value, the asset will be viewed as impaired for the difference, and

the return will be decreased by the impairment expense. Conversely, if the company management aims to obtain an “optimistic attitude” related to the return, it will deem that there are no indications that the assets underwent impairments, thus avoiding to decrease the return.

✎ *the impact of the lease-back operation on the return of the company*

The lease-back operation is a creative accounting technique and consists of selling an asset to a leasing company, immediately followed by its financial lease takeover. By this method, the business entity obtains the economic resources required for a normal activity and, at the same time, it can continue to use that asset, as if it were still the owner of the asset. In the year of the transaction the return is increased, but it will decrease in the following years due to the lease instalments paid by the company. The higher the price of the transaction, the higher the lease instalments and interest rates paid by the company and consequently the return will be affected accordingly.

✎ *modelling the accounting result in the context of the alternative depreciation methods allowed by the accounting standards*

The choice of one or another **depreciation method** related to an asset, throughout its useful life, has a different impact on return over time, depending on the scheduling of depreciation expenses on periods. Thus, the various depreciation methods have a different impact on the result, depending on the selected method, the distribution of the depreciation expenses over time being changed:

- *The straight-line method* leads to constant depreciation expenses throughout the useful life of the asset;
- *The declining balance method* is substantiated in a decreasing depreciation expense throughout the useful life of the asset;
- *The accelerated method* leads to higher expenses in the first year, resulting in the decrease of the return, and in uniform costs throughout the remaining period.

✎ *the option for the useful life of the assets has an impact on the performance of the business entity*

The various options related to the useful life lead to different depreciation expenses, and to different images of the return respectively. The review of the useful life leads to the adjustment of the depreciation expenses corresponding to the current period and to the future periods. The deduction of the remainder value results in the decrease of depreciations and therefore the increase in the return of the accounting periods.

In order to avoid this trap, external users interested in the performance of the two companies must make sure that the depreciation periods of the assets in question are comparable.

✎ *the accounting treatment of the expenses incurred after commissioning the tangible assets*

The subsequent expenses corresponding to an item such as land and fixed assets that has already been recognize, should only be added to the book value of the asset when it is deemed that the company will get future additional economic benefits compared to the performance initially assessed as appropriate.

For example, we believe that a company revamped, at the beginning of accounting period N, the building in which its administrative compartment operates. The building was purchased 18 years ago, for an original cost of 500,000 m.u., its useful life being 20 years. The revamping expense was 40,000 u.m.

The managers deem that the building is highly deteriorated, and that it is necessary to revamp it in order to continue to ensure its functionality. The solution proposed is not to capitalize the revamping expenses. On the other hand, the company

management intends to purchase new headquarters and to sell the old one, and hopes to increase the market value of the later by revamping it. Consequently, it could decide to capitalize the revamping expenses.

The question is: *Which will be the impact on the return?* In order to provide the appropriate answer, we are showing below an excerpt from the “Profit and loss account” of the company in the two possible cases: when the revamping expenses are not capitalized, or are capitalized respectively.

**Table 2. Impact of the accounting treatment of the revamping expenses on the performance of the company**

Name	Accounting period N		Accounting period N+1	
	Revamping expenses		Revamping expenses	
	Capitalized	Non/capitalized	Capitalized	Non/capitalized
Turnover	609,107,045	609,107,045	609,107,045	609,107,045
Revamping expenses	-	(40,000)	-	-
Depreciation expenses	(45,000)	(25,000)	(45,000)	(25,000)
Raw material and consumable expenses	(108,035,585)	(108,035,585)	(108,035,585)	(108,035,585)
Wages and social expenses	(239,664,624)	(239,664,624)	(239,664,624)	(239,664,624)
Other operating expenses	(172,604,763)	(172,604,763)	(172,604,763)	(172,604,763)
Impact on the return	(45,000)	(65,000)	(45,000)	(25,000)
<b>Accounting return</b>	<b>88,757,073</b>	<b>88,737,073</b>	<b>88,757,073</b>	<b>88,777,073</b>

We can notice that in accounting period N, by the capitalization of the revamping expenses, the return of accounting period N is higher by 20.000 m.u. than when these expenses are not capitalized.

### 5. Creative application of the accounting standards concerning the recognition and recording of intangible assets

#### *regarding the development expenses*

An optimistic attitude concerning the chances of success of a development project will lead to the capitalization of the development expenses, with consequences on the size of the return, in the accounting period corresponding to the capitalization. In the future accounting periods, the recording of the depreciation expenses will have an impact on the return by reducing it.

*We will assume that a business entity carries out a research and development project that generates expenses amounting to 2,000 RON in year 1, and to 3,000 RON in year 2. The incomes generated by the project emerge in years 3 and 4 and amount*

to 3.500 RON/year. We assume that the incomes of the entity, except those generated by the project, amount to 10,000 RON/year.

The entity can choose one of the following accounting treatments:

a. The capitalization of the development expenses in the years when they were incurred, and their depreciation in years 3 and 4, when economic benefits are generated;

b. The capitalization of the development expenses in year 1 and their transfer into the profit and loss account at the end of year 2, as a result of the emergence of uncertainties concerning the completion of the project;

c. Including all expenses in the *Research* category.

The effect of the three treatments on the profit and loss account throughout the four years is shown in the table below:

**Table 3. Impact of the treatment of the development expenses on the performance of the business entity**

	Accounting period N	Accounting period N+1	Accounting period N+2	Accounting period N+3	Total
<b>Treatment "a"</b>					
Incomes	10,000	10,000	10,000	10,000	<b>40,000</b>
Incomes from the project	0	0	3,500	3,500	<b>7,000</b>
Depreciation expenses	0	0	(2,500)	(2,500)	<b>(5,000)</b>
<b>Return</b>	<b>10,000</b>	<b>10,000</b>	<b>11,000</b>	<b>11,000</b>	<b>42,000</b>
<b>Treatment "b"</b>					
Incomes	10,000	10,000	10,000	10,000	<b>40,000</b>
Incomes from the project	0	0	3,500	3,500	<b>7,000</b>
Depreciation expenses	0	(2,000)	0	0	<b>(2,000)</b>
Research expenses	0	(3,000)	0	0	<b>(3,000)</b>
<b>Return</b>	<b>10,000</b>	<b>5,000</b>	<b>13,500</b>	<b>13,500</b>	<b>42,000</b>
<b>Treatment "c"</b>					
Incomes	10,000	10,000	10,000	10,000	<b>40,000</b>
Incomes from the project	0	0	3,500	3,500	<b>7,000</b>
Research expenses	(2,000)	(3,000)	0	0	<b>(5,000)</b>
<b>Return</b>	<b>8,000</b>	<b>7,000</b>	<b>13,500</b>	<b>13,500</b>	<b>42,000</b>

We can notice that, although the cumulated return is the same for the four years, its structure within each year is different, depending on the accounting treatment chosen.

Accounting creativeness can also be manifested if there are costs common to several projects, and their delimitation on each project is subjective.

*regarding to the building contracts*

The choice between the two accounting methods used for building contracts has the following impact on the profit and loss account:



- Based on the completed contract, the return will be recognized when the contract is completed;
- Based on the percentage-of-completion method, the return will be spread over time throughout the whole duration of the contract.

The shift from one method to another also has a significant impact on the profit and loss account.

#### ☞ *regarding goodwill*

The undervaluation of the purchased assets of the company leads to the increase of goodwill. The capitalization of goodwill and its depreciation over its useful life have an impact on the return of the future accounting periods. The goodwill depreciation expenses lead to the decrease in the return, with consequences on the exchange rate of the stock and on the competitiveness of the competitive public purchase bids. The imputation of the goodwill from the equity capital leads to the decrease of the latter, and the return of the future accounting periods is not influenced by the depreciation of the goodwill.

We believe that these methods contain a certain “dose” of accounting creativeness that is subjective in nature, with the realization of the fact that they change the presentation of the performance of a business entity. Such creative methods are the result of an option when they are selected from among several methods, while still being within the accounting regulations.

In most cases where creative accounting is used, the selection and application of the accounting policies are within the limits of the flexibility of the accounting standards and regulations. The manner of applying the accounting policies is based on professional judgement. However, there are many cases when such judgement leads to damage of the disclosed return and financial position.

The creative accounting techniques related to the revaluation of assets are usually used by entities in distress with the purpose of increasing their equity capital (revaluation reserves) and thus to artificially increase borrowing capacity.

Another place where creative accounting is manifested is the production of assets, by recording fixed expenses (wages and depreciation) corresponding to the sub-activity in the asset value.

## 6. Conclusions

In our opinion, creative accounting is a tool in support of the manager, used to promote and support the image of the company managed by him and to select the information in such a way as the data provided may support the interest pursued by him.

The presence of options in accounting, in the context of the liberty to choose and asses, allows the company manager, depending on the pursued interests or the inclination towards optimism or pessimism, to be tempted to reverse judgements or to translate into accounting certain legal, economic and financial innovations, for which the normalization has not found solutions yet. This can create opportunities for subjectivism and creative accounting, which can result in modelling the return and the content of the financial statements.

Creative accounting must be approached both in its negative and its positive sense.

The economic, legal and social development, but also the pressure of the users of the financial information made accounting innovation necessary, and thus led to the development of creative accounting.

The positive side of creative accounting or of the creativity in accounting refers to the application of the best options, the ultimate purpose being that the financial information should reflect a fair image of the financial position, the performance and the change in the financial position of a company.

In both forms of creative accounting, i.e. the positive and the negative one, there is a threshold that, once exceeded, allows for passing from one form to the other, as follows: the Conceptual Accounting Framework of IASB admits in paragraph 34 that "*most financial information is subject to some risk of being less than faithful*".

The lower this risk is, the more credible the information, and consequently we can talk about positive creative accounting. Conversely, the higher this risk is, the less credible the information, which leads to negative creative accounting.

The same Conceptual Framework of IASB also provides a solution for this risk related to the decrease of the reliability of accounting information, by the specification on paragraph 46 namely "*the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information*".

## References

- Bertolus J.J. (1988), *L'art de truquer un bilan*, Science & vie économie, 40, 58-60.
- Colasse B (1995), *Contabilitate generală*, Editura Moldova, Iași.
- Gounin I. (1991), *L'art de présenter un bilan*, La Tribune, 10-11.
- Malciu L. (1999), *Contabilitate creativă*, Editura Economică, București.
- Munteanu, V., Zuca, M. (2011), *Considerații privind utilizarea contabilității creative în denaturarea informațiilor din situațiile financiare și "maximizarea" performanțelor firmei*, Audit financiar, IX, 3, 7.
- Naser K. (1993), *Creative financial accounting: its nature and use*, Editura Prentice Hall International, Londra.
- Pourqueri D. (1991), *Les provisions ou l'art de mettre de l'argent de côté*, Science & vie économie, 73, 72.
- Shah A.K. (1988), *Exploring the influences and constraints on creative accounting in The United Kingdom*, European Accounting Review, vol. 7, 1, 83-104.
- Stolowy H. (2000), *Comptabilite creative*, Encyclopedie de Comptabilite, Gestion et Audit, Editure Economique, Paris.
- Trotman M. (1993), *Comptabilite britannique, mod d'emploi*, Editure Economique, Paris.