

## Possibilities of Influencing the Results of an Entity through Creative Accounting at Stock Level

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### Abstract

*The reality of these days proved the fact that, real and opportune economical – financial information represents the key to decision grounding by the different categories of users. However, the complexity of the economic life, but also the normative changes, have led to the development of procedures and techniques which allow an “embellishment” of financial reports in which the information are reflected. In order to have a more profound vision on the activity carried out by an entity, the users of financial reports have to be able to identify both the implementation of these techniques, as well as the resulted modifications.*

*According to the utilized mechanisms, the creative accounting impacts both the result and the balance sheet. Among the procedures which have an influence on the result modelling, the ones concerning stocks shine.*

**Key words:** creative accounting, stocks, economical – financial information.

**J.E.L. classification:** M40, M41

### 1. Introduction

“Nowadays, accounting may be defined as a remodelling instrument or an instrument of representing the entity, which allows to its leadership to provide financial reports concerning the situation and its realisations, which are to be presented to different economical and social partners, to the parties which are interested in its existence, for helping them with the decisions which regard the entity.” (Colasse, 2009, p.69)

The process of globalization and especially the complexity of the contemporary economic life, increase the importance of the information reflected in financial reports for taking some decisions. Therefore the quality of decision is influenced by the quality of information having a great impact on the results of that company. “Although the financial information is produced in a legal framework which regulates the rules of its presentation in a quite accurate manner, in practice it is ascertained that it is practised a correction of result and a legitimate and legal adjustment of result, by many entities which take advantage of the flexibility of accounting and juridical rules, from where the concept of creative accounting comes from.” (Cernușca, 2004, p. 385). Therefore the usage of creative accounting has extended to fixed assets, stocks, provisions, amortisation, commercial fund, capitals, claims and not only, but given all that, a trusty image of the entity may still be given.

Within the entities which have manufacturing activities, a significant weight is detained by current assets, and among these, stocks shine, having an important role in the good development of the entity’s activity; that is the reason why the correct recognition and valuation of these elements is essential for providing a trusty image through financial reports, so that the users may have a solid base when making a decision. By intervening on the way in which the stocks are reflected within the financial reports, the entity’s result is influenced.

Creative accounting has different procedures which have an impact on the result and which use as mechanisms the complexity of aspects concerning stocks, aspects which allow the voluntary finding of error in determining the size of the stock, using different methods of evaluating these elements as well as including or not some expenses in the cost of these stocks.

This scientific approach pursues an actual, complex matter referring to creative accounting's possibility to influence the determining of the stock size of an entity and implicitly the result of that entity.

## **2. Methodology**

The utilized methodology for fulfilling the purpose of this scientific approach includes both a theoretical research, as well as an empiric one. The theoretical research is an explanatory qualitative one and includes the study and analyze of regulations, studies and some financial accounting papers, respectively the creative accounting. The empirical research is a quantitative, descriptive research and it pursues different practical aspects of creative accounting in the stock field.

## **3. Theoretical background: Aspects concerning stocks**

"Stocks are assets detained for being sold during normal business, in the course of production for sale during the normal business, under the form of raw materials, materials and other consumables which are to be used in the process or manufacturing or for provision of services." (IAS 2, 2015, paragraph 6).

"Stock evaluation in the entity's current accounting and financial reports is made following the general norms of valuation, elaborated in accordance with the fundamental accounting principles." (Ristea, 2005, p.158). "According to the International Standards, stock valuation is made at the lowest value from the cost and net realisable value." (IAS 2, 2015, paragraph 8). It is also important for the evaluator of an entity to know the valuation method used for stock within the entity. "If the method through cost is used, it is also necessary for him to know the specific used method which can be: the weighted average cost method, "first in – first out" method (FIFO), "Last in – first out" method (LIFO)." (Stan et al, 2007, p. 296).

"In conditions of price increasing, a phenomenon which is almost normal in each economy, FIFO method is the leading one in making and presenting a more credible and relevant balance sheet (final stocks appear at the most recent prices) and a less credible and relevant profit and loss account (the consumables are registered at costs offset revenues). In the same context, the effects of applying the LIFO method are completely opposite: a more reliable and relevant profit and loss account, a less reliable and relevant balance sheet. It is inferred that choosing a method or other of evaluation regards the objectives which we formulate and a hierarchy of values." (Feleagă, 2006, p. 33-44). "Using the weighted average cost, the most utilised method in Romania, leads to obtaining a profit situated between the profit made by applying the FIFO method and the one obtained by applying LIFO." (Costi, 2016, p. 30-39). Therefore the accounting treatment referring to stocks influences the period's fiscal result. Using different methods of stock evaluation (FIFO, LIFO, weighted average cost), lead to different fiscal results.

## **4. Aspects specific to creative accounting**

"Creative accounting is in the time gap which has always existed between the financial innovation and normalization, this always being more or less the trail of the latter. It evidently meets a great development in the times of strong financial innovation, like the one known on the fund of financial globalization at the end of the last century." (Colasse, 2009, p. 69).

"Creative accounting consists in the assembly of techniques, options and liberties left by accounting texts, which without alienating from accounting norms or exigencies, give the entities' leaders the possibility to juggle with results or to modify the aspect of the accounting documents of synthesis." (Gillet, 1988, p.83) The opportunities of developing the creative accounting are given by the entity's possibility to choose among the different accounting methods, by the possibility of

entering into artificial transactions, planning the authentic transactions as well as the tendency to estimate.

A classification of the techniques and procedures of creative accounting may be done starting from the effect that these have either on the results, or on certain balance sheet items, according to the indicators that the entity wants to manipulate:

“- results account and accounting policy: modification of current result and of net result (amortisations, provisions, stocks, display of expenditures), modification of current result without influencing net result, modification of net result without influencing the current result (investment grants), taxation and accounting policy (activating the expenses)

- results account and management decisions: amelioration of current result (amelioration of manufacturing, attenuating or transferring the losses), amelioration of net result (lease-break).

- balance sheet amelioration techniques: own capitals (assets revaluation, financial collations), permanent loans leasing), the need for working capital and treasury (discounting trade effects).” (Cernuşca, 2004, p.403-404).

In order to point out a series of procedures and techniques specific to creative accounting, for exemplification certain aspects concerning the accounting treatment of stocks will be presented.

Stock domain offers plenty of opportunities for subjectivity and creative accounting. Therefore, an error voluntarily ascertained in determining the size of the existent stock at the end of the financial exercise may lead to a “polishing” of result, in the sense that undervaluation or overvaluation of final stock impacts not only the financial situations of current result but also the ones belonging to the next exercise. The entity’s management can opt for including or not the dead or obsolete stocks in, respectively from the management of the entity, according to the optimism or pessimism that they manifest. Also, “the different methods of valuating the output stocks lead to different images of the result. Inclusion or non – inclusion of some expenses in the stocks’ purchasing cost create opportunities for subjectivism and creative accounting. Therefore if the entity has the interest of diminishing the result with the purpose of paying a tax as small as possible, then this will eliminate a series of expenses from the production cost. Including financial expenses in the production cost has the effect of increasing the result, and on the other hand the entity can opt for considering the interests as items of expense of the exercise’s result.” (Cernuşca, 2004, p.406 – 407).

## 5. Study Case Concerning the Creative Accounting’s Procedures and Techniques Referring to the Accounting Treatment of Stocks

### Case 1: Treatment of stocks considered as being dead or obsolete

Entity S.C.EXAMPLE S.A., with the activity object – production, had dead stocks of 2000 Ron. The entity has the possibility for either excluding them from the management, or keeping them. The decision affects the entity’s result.

Table no. 1 Statement from` profit and loss account`

Nr. Crt.	Indicators	Management opts for excluding the dead stock from the management	Management opts for keeping the dead stock from the management
1.	Fiscal value	56000	56000
2.	Other operating incomes	1600	1600
3.	Material expenses	23000	23000
4.	Other outside expenses	600	600
5.	Staff expenses	17000	17000
6.	Amortisation expenses	500	500
7.	Other operating expenses	2000	-
8.	Operating result	14500	16500

Source: own creation

In the situation when the entity manifests accounting pessimism it opts for excluding the dead stock of 2000 Ron from their management by passing them on expenses. As a result, the entity’s result will be diminished by the value of these stocks.

In the situation when the entity manifests accounting optimism it opts for keeping the dead stock of 2000 Ron from their management, thinking that these may be valued in the period when economical recessions take place.

In the balance sheet, the entity's option for excluding or keeping the dead stocks manifests at the level of indicators such as Current assets, Net current liabilities, Total assets minus current debts, Own capitals, their value being smaller in the case of exclusion of these elements.

**Case 2: Undervaluation, respectively overvaluation of final stock**

Entity S.C.EXAMPLE S.A., with the activity object – production, purchases raw materials at an acquisition cost of 8600 Ron. At the end of the financial exercise it is estimated that the net realisable value is 7000 Ron, in the case of undervaluation, respectively 9000 Ron in the case of overvaluation.

*Table no. 2 Determining the stock at the end of the financial exercise*

Nr. Crt	Stock	Acquisition cost	Net realizable value estimated on 31.12.N		Stock value in the financial reports		Stock depreciation	
			Undervaluation	Overvaluation	Undervaluation	Overvaluation	Undervaluation	Overvaluation
1.	Raw materials	8600	7000	9000	7000	8600	1600	-

Source: own creation.

In the case of under valuating the final stock, the entity follows the diminishing of the exploitation result. Therefore, according to the regulations in effect, at the end of the financial exercise, the stock will appear in the balance sheet with the value of 7000 Ron, estimated realisable value, at the same time registering an expense with stock depreciation, which will have the effect of reducing the result, implicitly the paid tax.

In the case of over valuating the final stock, the entity follows the increase of exploitation result. Therefore the paid tax by the entity will be higher, but over valuation of the working capital and of current net assets also takes place.

**Case 3: Including or not some financial expenses in the production cost of the stocks**

Entity S.C. EXAMPLE S.A. with object of activity – production, obtains in December 70 pieces of the product A, having productions expenses of 39200 Ron,. As a result of retreating in the management accounting, the structure of these expenses become: variable expenses: 25000 Ron, fixed expenses 14200 Ron. Over the time, 50 of these pieces from A product are being sold at a unitary price of 690 Ron.

The calculus of the production cost using the global method, respectively the direct cost method:

*Table no. 3 Comparative presentation of the entity's result according to the cost calculus method*

Nr. Crt.	Indicators	Global method	Direct cost method
1.	Incomes from selling the finished products	34500	34500
2.	Stock variation	11200	7142.50
3.	expenses	39200	39200
4.	Result	6500	2442.50

Source: own creation

1. Global method

Obtaining the finished products

Finished products = Stock variation 39200

Discharge management of sold finished products

Stock variation = Finished products 28000

$$39200 : 70 = 560$$

$$50 \times 560 = 28000$$

Stock variation, final creditor balance = 39200 – 28000 = 11200 lei

## 2. Method of current costs

Obtaining the finished products

Finished products = Stock variation 25000

25000 : 70 = 357,15 – the cost includes only the variable expenses

Discharge management of sold finished products

Stock variation = Finished products 17857.50

50 x 357.15 = 17857.50 lei

Stock variation, final creditor balance = 25000 – 17857.50 = 7142.50 Ron

It can be observed that in the case of direct cost method, a smaller result is obtained as in the case of global method, as a result, the entity will pay a smaller profit tax. This fiscal advantage consists only in the delay in time of the tax payment because if in the following month nothing will be produced, and there will only be sold the remaining 20 pieces of A product, a higher result will be registered, in the conditions of applying the direct method.

### Case 4: Applying the different methods of valuating the output stocks

Entity S.C. EXAMPLE S.A., with object of activity – production, has an initial stock of 40 products, unitary cost 60 Ron/piece, inputs are 70 pieces, unitary cost 80 Ron/piece. The outputs during the time are 80 pieces. Selling price is 100 Ron/piece.

For determining the result and making a comparison the three methods of valuation the output stock will be made, respectively FIFO, LIFO, weighted average cost.

Table no. 4. FIFO method

Nr. Crt.	FIFO			
1.	Initial stock	40 pieces	60 lei/ piece	2400 lei
2.	Inputs	70 pieces	80 lei/ piece	5600 lei
3.	Available for selling	110 pieces	-	8000 lei
4.	Final stock	30 pieces	80 lei/ piece	2400 lei
5.	Cost of sold goods	40 pieces	60 lei/ piece	2400 + 3200 =5600 lei
		40 pieces	80 lei/ piece	

Source: own creation

Table no.5 LIFO method

Nr. Crt.	LIFO			
1.	Initial stock	40 pieces	60 lei/ piece	2400 lei
2.	Inputs	70 pieces	80 lei/ piece	5600 lei
3.	Available for selling	110 pieces	-	8000 lei
4.	Final stock	30 pieces	60 lei/ piece	1800 lei
5.	Cost of sold goods	70 pieces	80 lei/ piece	5600 + 600 = 6200 lei
		10 pieces	60 lei/ piece	

Source: own creation

Table no. 6 CMP method

Nr. Crt.	CMP			
1.	Initial stock	40 pieces	60 lei/ piece	2400 lei
2.	Inputs	70 pieces	80 lei/ piece	5600 lei
3.	Available for selling	110 pieces	72.73 lei/ piece	8000 lei
4.	Final stock	30 pieces	72.73 lei/ piece	2181.90 lei
5.	Cost of sold goods	80 pieces	72.73 lei/ piece	5818.40 lei

Source: own creation

Table no. 7 Synthesis picture of the final cost of the stock, of cost of sold goods and of brut result

Nr. Crt.	Indicators	FIFO		LIFO		CMP	
1.	Sells		8000 lei		8000 lei		8000 lei
2.	Initial stock	2400 lei		2400 lei		2400 lei	
3.	inputs	5600 lei		5600 lei		5600 lei	
4.	Available for selling	8000 lei		8000 lei		8000 lei	
5.	Final stock	2400 lei		1800 lei		2181.90 lei	
6.	Cost of sold goods		5600 lei		6200 lei		5818.40 lei
7.	Brut result		2400 lei		1800 lei		2181.60 lei

Source: own creation

Applying the FIFO valuation method leads to obtaining a minimal value of cost of the sold goods, final stock being maximum, therefore an increase of the exploitation result is obtained and implicitly, of profit tax. Applying the CMP valuation method, determines a medium value of the cost of sold goods, final stock also being medium.

Applying the LIFO valuation method leads to obtaining a maximal value of cost of the sold goods, final stock being minimal, therefore a diminishing of the exploitation result is obtained and implicitly, of profit tax. For these reasons, LIFO method is considered as being the optimal method of valuation the output stocks.

## 6. Conclusions

Due to the fact that the field of stocks is a complex one, and the economical environment in which the entities develop their activity is in a continuous change, accounting professionals are forced to seek different ways to "decorate" the financial reports, due to the fact that the stock domain is a complex one, and the economical environment in which the entities develop their activity is in continuous change, the professional accountants are forced to find different ways to "embellish" the financial reports, therefore being able to influence the size of the stock and the presented result. Concerning dead stocks, the value of the indicators in the balance sheet is lower when these stocks are being taken out form management. The operating result may be increased or lowered according to the entity's decision to over evaluate or under value the detained stock. Referring to including or not certain financial expenses in the stocks' production cost, the purpose is the one of influencing the taxation. These things are possible by appealing to techniques and principles of creative accounting, which many times are at the border between legality and fraud.

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