

## **Analysis of Creative Accounting – Faithful Image Relationship and Creative Accounting – Fraud Relationship**

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### **Abstract**

*Due to the extreme sides specific to creative accounting – positive and negative, faithful illustration of reality and fraud with the purpose of misleading and defrauding, moral and immoral, rigid and flexible and due to the fact that between these extreme characteristics there are a series of accounting options which lead more to what good and correct means or in the opposite direction to manipulation and fraud, we intend to highlight all these aspects in order to make clear for the readers what means a faithful image and what it depends on; we also want to help the user of accounting information to understand the reasons behind the manifestation of each mentioned extreme, the benefits and risks of using it.*

**Key words:** creative accounting, fraud, faithful image

**J.E.L. classification:** M41, M48, H30, H87

### **1. Introduction**

Creative accounting became in the last two decades a topic approached by many specialists in the field, but its treatment is still insufficient.

It is very important to understand where we make the delimitation between manipulation at the limit of legality and fraud both for the accounting experts and for other categories of users of accounting information. It is also important to understand that sometimes it is a very smooth line between the two concepts, and unlike fraud, creative accounting only exploits the imprecisions and incompleteness of accounting regulations, which is not always a moral practice or a practice which is based on the intention to faithfully reflect reality, on the contrary it has the intention to cheat, to mislead. There are many opinions for and against the use of creative practices, the flexibility of norms gives accounting options which privilege certain categories of users and underprivilege other categories of users. Our purpose is to draw the attention to these issues so that the users of accounting information can analyse as objectively as possible the figures presented by the financial statements, we are not for or against these creative accounting techniques, but we want to make known its limits and the limits to which they stay legal, it is for everyone to consider up to which limit they are moral.

### **2. Theoretical background**

Michel Capron, in one of his works has asked himself the question: "Is there an accounting truth?", and this question was also the title of a chapter of this book. At the end of this chapter the author answers as follows: "To the question asked at the beginning of the chapter "Is there an accounting truth? We can answer safely negatively." At the end of his writing, the author states: "Accounting is not only an instrument, it is also a social phenomenon crossed by the contradictions of society and it became a stake for different social protagonists, each trying to take advantage depending on his/her own interests" (Capron, 1994, page 156).

The concept of faithful image has Anglo-Saxon origin (true and fair view) and was used for the first time in the year 1947 in the text of companies law of Great Britain (Companies Act) where it mentioned as follows: "each balance sheet of a company has to give a faithful image of the company businesses, at the end of the fiscal year and each profit and loss account of a company has to give a faithful image of its result for the fiscal year" (Malciu et al, p. 335).

The equivalent of faithful image in French accounting reference is the honesty; this concept appeared in the French law in 1937. Honesty had the mission to serve as qualitative criterion and as reference in the control of reliability of accounting information. Certainly, it corresponds to the intention to be as close to reality as possible. The honesty encountered in the French system has gradually got farther from the faithful image of the British system; thus, honesty is regarded as meaning the conformity with the rules and is transposed in the observance of rules imposed by laws, customs, regulations.

Trying to give a definition to the concept of faithful image, Lee mentions as follows: "Today the faithful image has become a term of art. It involves the presentation of accounts drawn up according to the generally accepted accounting principles, the use of numbers as exact as possible, the realization of as reasonable estimates as possible and their arrangement so that we can provide, with all the limits of current accounting practices, the most objective image possible, devoid of errors, distortions, manipulation or significant omissions. In other words, we have to envisage both the letter and the spirit of the Law" (Lee, 1981, p. 270).

Amat O. analysed this definition and highlighted the following issues:

- The reference to the reasonable estimates and to the limits of current accounting practices involves a certain tolerance to certain inevitable imprecisions. "It is preferable to approximate than to make a mistake with accuracy", said J.M. Keynes, who can explain the replacement of the requirement of true and correct view with the true and fair view. Thus regarded, the creation of faithful image can be considered a true incentive in the use of techniques and mechanisms of creative accounting.
- The most objective image possible -this expression means actually the treatment with a neutral attitude – which is already manifested and expressed as a principle in accounting regulations. Neutrality involves a way of selection and presentation of information, the financial statements which does not influence the decisions of users of accounting information and which does not lead to a predefined result. Analysed from this perspective, faithful image is against the adoption of creative accounting practices;
- The reference to omissions and to the letter and spirit of the law has determined certain specialists to consider that this requirement of true and fair view is much more rigorous because: true means the letter of the law and fair (faithful) symbolises its spirit. Analysed from these points of view, the concept of faithful image is opposed to the use of creative accounting practices;
- If a court of law should have to decide whether the financial reports made by a company present or not a faithful image, this would be difficult to invoke, because other appreciation criteria do not exist except the conformity with the generally accepted accounting principles. Analysed from this angle, the concept of faithful image supports the use of creative accounting methods and practices (Amat et al, 1999).

### 3. Methodology

This approach is mostly qualitative, opinion-based and overall descriptive. This paper uses as a method of research both descriptive and exploratory, was followed the deductive nature and used the presentation and explanation of the cause-effect relationships; it has also an inductive nature and various interconnection relations with direct and indirect involvement factors were followed.

For data collection we used studies and reports published by various specialists and organizations to obtain a comprehensive description of the issues addressed.

#### **4. Faithful image – creative accounting relationship**

We have to mention that in the British accounting regulations this notion was never defined explicitly. We consider that this faithful image concept is a relative one; each user of accounting information has his/her own perception of what faithful image means. Therefore, the creative accounting has a negative impact on the reflection of a faithful image if this flexibility that the accounting norms allow is used with the purpose of making reports to the detriment of majority and in favour of a low number of users of accounting information.

The continental accounting system considers, in general, that the practice of creative accounting is an obstacle in realization of a faithful image and represents a deceitful and unwanted practice; on the other hand, the Anglo-Saxon accounting system proves a higher flexibility and considers creative accounting as a necessary thing to keep up with the economic, social and legal evolutions.

The concept which prevails in accounting – the faithful image – has generated two major opinions (Feleagă et al, 2005, vol 1):

1. The Anglo-Saxon opinion which we find in countries in which we distinguish accounting from taxation and where the financial statements represent a synthesis of financial accounting and management accounting. In other words, accounting mirrors the economic reality and is perceived as an information system regarding the company and about the company. The opinion spread in these Anglo-Saxon countries is that the faithful image depends on the professional reasoning which is an expression of professional art. This method of presentation should lead to an image which does not suffer intended deformations, manipulation or omissions of significant information.

2. The continental opinion – according to this opinion, in some countries the accounting was and still is perceived as a tool in the service of the state which has to assure a correct tax base for the calculation of taxes and duties. In order to reflect a faithful image, by the annual financial statements of reporting, the accounting has to be run based on own principles, without proceeding to misrepresentation by the adjustments made to the values for exclusive fiscal purposes.

The convergence of European accounting with the concept of faithful image has started with the Directive IV, whose provisions set forth as follows:

- a) annual accounts (balance sheet, profit and loss account and annexes) have to offer a faithful image regarding the patrimony, financial situation and result;
- b) when the application of directive is not sufficient, in view of obtaining a faithful image, further information has to be provided;
- c) for the purpose of respecting the principle of faithful image, the application of the other accounting principles can be abandoned in exceptional cases, more exactly when their use leads to the creation of an image which is not faithful, assuming that a faithful image is obtained in this case only by the lack of conformity with the rules in force. We can see though the more restrained nature of derogation than in the Anglo-Saxon area.

We can conclude that the continental concept considers creative accounting as an obstacle to the illustration of a faithful image and represents an unwanted fraud practice; on the other hand, the Anglo-Saxon concept proves a certain flexibility and appreciates as necessary the manifestation of professional reasoning, freedom of choice, judgement in the building and illustration of a faithful image.

#### **5. The relationship between creative accounting and fraud**

The concept of fraud refers to an action intently carried out by one or more persons from the management or those responsible for governance of employees or third parties, actions which involves the use of fraud with the purpose of acquiring an unfair advantage.

Fraud appears as effect of events such as:

- Manipulation or changes of entries or documents (forged with the purpose of misrepresentation or to hide the truth);
- Embezzlement of assets or theft of assets;
- Inadequate allocation of certain assets, which leads to a worsening of financial situation of an entity, which can have direct consequences in business continuity of the company;

- Removal or omission of effects that some transactions or entries of fictitious transactions have with the purpose of making-up the financial statements;
- Willful wrong application of accounting norms with the purpose of presenting financial statements which are meant to mislead the users.

Brown P.R. defines fraud as "Forgery, change or destruction of documents, recording of false operations or dissimulation of important information"(Brown, 1999, p.61-63).

IFAC (International Federation of Accountants) defines fraud as "an intended act committed by one or more individuals from management, persons responsible for the governance of employees or third parties, which involves the use of fraud to obtain an unfair or illegal advantage"( IFAC, 2009). Therefore, fraud has a negative nature, violates the law and must be punished accordingly.

Fraud can also be committed by:

- Forgery of accounting entries or supporting documentation based on which the financial reports are made;
- The incorrect application of accounting policies (overvaluation of amounts from current sales);
- Recording of transactions which were not made (recording of fictitious sales);
- Destruction of entries or documents regarding the results of transactions;
- Embezzlement of assets (theft or abuse of assets which belong to the entity such as hiding sales, fraudulent invoices, fraudulent payments).

Unlike fraud, creative accounting only exploits the imprecisions, incompleteness of accounting regulations. Thus, if for the resolution of the same problem there are many accounting treatments, we will choose the variant which will lead to the result targeted by the management.

From ethical point of view, just as blaming are these techniques which, even if they do not violate the accounting regulation and cannot be punished or restricted, they alter the economic reality. On the other hand, when it is used with good faith, it is a necessary instrument in building and illustration of a faithful image.

Therefore, we cannot consider fraud and creative accounting as synonyms. Both of them represent intended actions, but creative accounting is made with the observance of the law, but is not made in the spirit of the law. Creative accounting is a legal practice, can even be an instrument for representation of faithful image, when it is used with good faith. But we can prove that it is closer to fraud, if the flexibility of norms is used for the purpose of obtaining certain advantages for certain categories of users, to the detriment of other categories of users.

Considering that in the last two decades the economic reality was shaken by many financial scandals, the specialized publications have started to pay more attention to the creative accounting phenomenon.

The concept of creative accounting appeared in the years `80s in Great Britain and made reference to the accounting artifices used for the purpose of maximising results and attracting investors. The topic was less treated at that time, its approach with higher interest appeared only after resounding financial scandals. Often a general vision of creative accounting is brought close-up and the way in which we can remove this phenomenon of manipulation of numbers is less detailed. In `90s more works on this subject began to be written, among which reference works are authors such as Kamal Naser „Creative financial accounting-its nature and its use" in 1993, Bernard Colasse „Lorsque la comptabilité creative se met a deraper" in 1993, Francois Bonnet „Pieges (et delices) de la comptabilité (creative)" Paris, 1999, Stolowy H „Comptabilité creative" Paris, year 2000.

Analysing the studies and definitions of this period we notice that the academic authors do not highlight the appreciation of legality or illegality of these accounting practices, their focus is not creative techniques. After 2000, the explosion of technology and the resounding financial scandals of reputed companies such as a Enron, Parmalat, Tyco, etc have incited the interest of accounting experts regarding this topic. These scandals have also diminished the trust in the information presented in the financial statements even when they were audited.

This topic became more and more interesting since then, the manipulation of accounting figures became a subject of interest because the manipulation of figures became a more and more frequent practice.

Thus, in the following years the specialised literature presented new perspectives for creative accounting. An example in this respect would be the work of Lorne Steward Cummings from 2007 „How to cook your book-a recipe for disaster” in which the writer uses a metaphor to convey the idea that it takes ingredients and a method when we talk of creative accounting. Among the ingredients he mentions the despair, lack of ethics, lack of experience.

In 2009 M. Omurgonulsen and U. Omurgonulsen say in the study that ”the deficiencies between the legal framework for the banking sector and the legal accounting framework, the mismatches between the governmental regulation autonomy and the autonomy of supervisory bodies, the practical difficulties in the application of legal and ethical norms caused by the slow functioning of judicial system are justified reasons for the creative accounting practices in addition to the greed of owners and top managers. However, the intention and capacity of political power to fight against the corruption problems of this kind are also crucial”( Omurgonulsen, 2009, p. 651-673).

Another author says in 2010 that ”when the rules and laws are clearly established” creative accounting remains a problem (Mc Barnett, 2010, p. 396-386).

While in foreign literature there are many works on this topic, in specialised literature of Romania the approach is still insufficient.

## 6. Conclusions

If the purpose of creative accounting is supposed to improve accounts (or the image that they give to the economic entity), by taking advantage of the weaknesses and carences of accounting regulation, we consider that this concept does not bring anything new because the principle of options has been known to accountants for a very long time.

Fraud, on the other hand, does not have anything creative, it is illegal. The ”illegal” procedures are not worth mentioning, because in such mechanisms there is nothing creative most of the times. In most cases when creative accounting manifests itself, the application and choice of accounting policies integrate in the limits of flexibility of rules and accounting standards.

The way in which the accounting policies are applied is based on the professional judgement of the person who applies them. In many cases, this judgement leads to prejudice of entities' results and the financial position reported for them. This is about an aggressive application of accounting policies and we make reference to a fraudulent reporting.

When the accounting practices exceed the limits of accounting regulations, thus the financial statements do not present a faithful image of the result and financial position. In order to decide if it involves a fraudulent financial reporting, we have to prove the intention. What represents an aggressive adoption of accounting policies in a first stage can be turned later into a fraudulent financial reporting if this approach is continued for longer periods of time and has as purpose significant amounts of money. However, it is not always easy to identify the moment when the use of creative accounting becomes fraudulent.

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