THE PRACTICAL APPLICATION OF THE ACCOUNTING INFORMATION IN THE CREDIT ACTIVITY THROUGH THE ASSESSMENT OF THE CREDITWORTHINESS OF THE CREDIT APPLICANTS

GÎNȚA ANCA IOANA
PHD STUDENT "1 DECEMBRIE 1918"UNIVERSITY OF ALBA IULIA",
e-mail:anca.ginta@yahoo.com

Abstract
Although banks have been conducting credit lending activities for centuries by using traditional credit risk assessment methods, the scientific art of credit risk management has evolved over the last few years along with the Basel agreement. The risks to which banks are being exposed when they fund societies keen on creative accounting techniques are considerable, the misleading attempts and the "production" of financial statements for a successful image in front of the bank in order to convince with a view to obtaining funding are often common practice. The consequences are particularly severe for the financing institution that will mark losses on the transaction concluded on the basis of these glossed over economic realities. That is why it is very important to look beyond this picture, to compare the image presented by the client with images of other reporting periods in order to identify changes in the accounting records techniques. It is best to understand the film of the last 2 or 3 years to grasp the reality of a society and not just the image that it has been thoroughly prepared to be shown to the bank in order to get credits.

Keywords: *creative accounting, creditworthiness, financing*

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

1.Introduction. The current economic context and the importance of the topic addressed

Often, the make-over of the financial statements does not fall within the scope of fraud, but it can improve aspects that an institution may take into consideration when performing a financial analysis. For example, a low-capitalization company below 10-15% is not expected to receive funding so it prepares its annual financial reporting so that its image may look better, and an "improvement" option is that of reassessing the assets through which the reserves in the revaluation increase and hence its equity. Observing these changes in the structure of finances can make us understand that nothing has actually changed in real terms, just in the records the society has found a way to adjust its performance indicators in order to become eligible for funding. By adjusting the level of capitalization by its artificial growth, the level of indebtedness is automatically adjusted in the sense of its diminution, thus checking two of the indicators assessed in the analysis process.

Another example of a practice is that a company has old unmarketable stocks that will not be funded by the bank and finds a loophole to get rid of the records' age of the stocks by changing their accounting software and by "renewing" them. The need for financing a working capital of a company takes into account current assets and current liabilities, being calculated as a difference between the two. The higher the stock eligible for funding - and here the old unmarketable stock does not come in - the higher the amount of funding.

Existence of large amounts in the debts account towards associates also raises questions as to the correctness of the registration of revenues but also to the legality of their registration. Although the legal regulations on income registration have been severely enforced in Romania lately, incomes generated by the activity of a company and totally undeclared continue to exist and they often return to society under the form of an associates' joint loan. These categories of companies involve additional risks and the assessment of their creditworthiness for financing is all the more difficult.

Therefore, banks need to know the creative accounting techniques and how they can be detected in order to avoid taking additional risks. Credit risk by definition is the probability that a loan will not be reimbursed. It is assumed up to a point by a financial institution, in a controlled and assumed manner. Beyond the limit set by the rules, it is important not to pass unconsciously by ignoring the misleading methods to which economic agents often seek in their desire to achieve their goals and meet their interests.

We will never know enough about the norms and the ways to bypass them, as they are constantly developing, people's creativity being without boundaries, and in order to deeply understand the economic reality it requires time, much information, experience and high perspicacity.

2.What is creditworthiness and how it is measured

"Client creditworthiness is a state of trust that shows the quality of the activity the clients are engaged in, in a previous period, at the present moment, but mostly in perspective, appreciated as a result of a thorough analysis performed by the banks, one of economic and financial nature, but also of a non-financial nature" (Regulation of BNR/NBR no. 3/2009 – M.O. 200/2009 3).

According to DEX (Explicative Dictionary), this is the debtor's ability to deal with the payment obligations at due date/ maturity.

An essential step in performing a client's creditworthiness analysis is to verify the legality of the documents submitted; this is the starting point for assessing the applicant's creditworthiness and for negotiating the terms in which it is to be credited.

The financial performances reflect the economic potential and financial solidity of an economic entity; this results from the analysis of a set of qualitative and quantitative factors (economic and financial indicators calculated on the basis of the data in the annual and periodic financial statements).

In the crediting process, according to Regulation of B.N.R./N.B.R. No. 3/ 2009, the quantitative factors refer to several indicators: profitability, liquidity, solvency and risk - including currency risk; qualitative factors relate to the way in which an economic company is managed, the guarantees received (other than those that are accepted in order to reduce exposure towards the debtor), the quality of the shareholders, the conditions of the market in which it operates, and to which it is reported. The most valuable guarantee for the bank must be the clients' creditworthiness and not the material guarantees.

The following creditworthiness indicators are usually calculated and analysed (Regulation of BNR/NBR no. 3/2009 – M.O. 200/2009 3):

A. *Liquidity ratio* – it is calculated as a ratio between the current assets of a company and its current liabilities; this ratio is set to be at a minimum of 120% and may be adjusted up or down depending on the sector, but a liquidity below 100% will never be tolerated, as it indicates a balance sheet imbalance that most often comes from financing fixed assets by short-term loans - a practice that is often handy but unhealthy on the long term.

B. *Operating profit margin* - it is calculated as the ratio between the operating profit and the turnover; with regard to this indicator, it is important that the result is positive, but depending on the sector, it will be viewed as good or bad at different levels; for example, it is absolutely normal for a producer not to have the same percentage of operating profit as a distributor or a carrier.

C. *Net profit margin* - it is calculated as the ratio between the operating profit and the turnover; as in the case of the operating profit margin, its level will be appreciated differently according to the field of activity of the analyzed company.

D. *The degree of indebtedness* - the method of calculating this creditworthiness indicator is different, but it expresses the same, namely what percentage of the company's assets is funded by financiers such as financial institutions and what percentage is funded by those who own the business – this last aspect denotes the degree of capitalization of a company.

Another way to estimate the level of indebtedness is the number of years in which a company can reimburse from EBITDA the loans - an optimal level is up to 3.5 years if we refer to the total of contracted loans and up to 2.5 years if we refer to short-term ones (with a credit period of up to 12 months). Again, there is the discussion concerning the field of activity - if, for example, we are talking about a producer it is essential to understand that he needs fixed assets far more than a service provider and as such the indebtedness ratio is higher for the producer.

E. *Capitalization ratio* – it is obtained from the ratio between the equity of a company and its total assets/ total liabilities; from here we realize how much the associates/ shareholders have invested in the assets of that respective company from their own pocket and how much it was bought on debt, how much of the retained earnings was reinvested. A minimum capitalization level for a company to be eligible for financing is 15%-20% depending on the type of funding requested.

In addition to these analyzes of financial statements, qualitative aspects may or may not enhance the creditworthiness of a client. For example, if a company owned in major part by a private person X has some very good indicators, but the majority shareholder has a bad reputation by holding other bankrupt companies or by being convicted of criminal offenses, these things lead to the impossibility to continue the process of analyzing a financing application.

In order to protect its own funds and those attracted from depositors, the bank has a duty to select its clients very carefully, as its performance is closely related to the efficiency with which the loans/credits are granted.

3. The connection between creditworthiness and creative accounting

Starting from the assessment manner of creditworthiness - analyzing the qualitative and quantitative aspects - we can say that both have a close connection with creative accounting, here intervening one of the motivational factors that are often used to manipulate the figures with the purpose of gaining advantages. This time, the advantages are not fiscal, as in the case of tax havens or profit mitigation methods, in order to reduce taxes due to the state budget; this time it is a different motivation, the flexibility of accounting standards being interpreted to maximize the profit. As it is said above, a client's creditworthiness is also measured by assessing a company's profitability and its ability to reimburse a funding is closely related to the profits earned.

"Creative accounting is the transformation of financial accounting figures from what they actually are to what their preparers want to show, taking advantage of existing rules and norms and/ or ignoring some or all of them." (Naser (1993: 2))

Some examples of accounting options that impact on the result, on the creditworthiness indicators and on the financing decision:

- IAS 36 requires that, at each balance sheet date, it is determined whether there is evidence that an analyzed asset has been impaired. A subjective management appreciates that there are no indications of depreciation of the asset, thus avoiding the diminution of the result with a possible expense with the depreciation.
- the option for one or the other of the depreciation methods of an asset during its useful life presents a different impact over time on the result, depending on the staggering on time periods of the depreciation costs. Thus, different depreciation methods have a different impact on the result, depending on the method chosen, by altering the distribution over time of the depreciation costs: - the straight line method results in constant depreciation costs over the useful life; - the digressive method is reflected in a decreasing depreciation expense over the useful life; - the accelerated method leads to higher expenses in the first year, with the effect of reduction the result, and to uniform expenses for the rest of the remaining period.
- different options over useful life lead to different depreciation expenses, respectively to different images on the result. Revision of the useful life leads to the adjustment of the depreciation expenses for the current period and for future periods. The deduction of the residual value has as

effect the diminishing of the depreciation and, consequently, the increasing of the result of exercises.
- the inclusion into the inventory of dead or morally exploited stocks is a method of manipulation. If dead or morally exploited stocks are removed from inventory, the expenses will be affected, with consequences on the result, in the sense of diminishing it. At the opposite end, the company's management may show an optimistic attitude, considering that these "dead" stocks can be capitalized, especially in the event of an economic recession.
- creating, increasing and reducing of provisions must be done with the help of the management's discernment, caution and foresight. Otherwise, it may sometimes be an opportunity to smooth the result. Overstatement of provisioning in high-yield years leads to a diminution of the result, and the resumption of revenue in the years when the company achieves a deficit leads to an increase of the result, both cases with impact on the establishment of profitability and of creditworthiness margins.
- the choice to resort to the revaluation of tangible assets has an impact on the increase in the value of the asset (increase of the depreciation expenses) and/ or the increase of own capital within the limits of the fiscal rules; thus, in situations where capitalization is a creditworthiness indicator that does not fit within eligibility for funding, revaluation of assets may lead to an artificial rise of the equity ratio and to a decrease of indebtedness - a creative accounting method that allows the improvement of 2 of the most important financial quality indicators.

Howard Schilit, in his book entitled *Financial Shenanigans,* declared that the Center for Research and Financial Analysis (CFRA) has identified 30 such techniques (grouped into seven categories) used by corporations in order to trick bankers and investors.

Any of these methods fall within the scope of creative accounting but do not fall into the category of fraud; they may be more or less ethical, sometimes easy to appreciate when the analysis is made over several financial reporting periods; however, prudence regarding the content of accounts when we assess qualitative indicators leads us to indices closer to the effective reality of a company and to how "healthy" it is led and managed.

4.Why it is important to assess creditworthiness in the financing process

Some analysts refer to the balance sheet as being a bathing suit - what it reveals is interesting, what it is hiding is vital. It is interesting to know if a company is hiding vital information or materials using the balance sheet, especially when you plan to lend that company money, and you have to make sure that their predictability confirms that they will be able to repay it in time.

Because we cannot predict the future with any certainty, it is difficult to give any loan that is completely risk-free. What we can do is to strive to minimize the risk associated with a logical evaluation of the available and required information and then do the correct assessment.Recent reports on the profile companies' failures focused on creative accounting and renewed their demands of published financial reports showing a complete and accurate image of a company's performance and position.

The current changes brought to technical regulations by regulatory authorities and standards standardizers (IAS, GAAP) have improved the transparency of financial statements and have come a long way in addressing the creative accounting techniques discussed here. The evolution of international standards - some completed, others in progress (such as leasing accounting) - will further close the gate for this form of manipulative accounting. While the tightening of the technical rules is advancing, creativity techniques are diversifying.

Accounting mistakes or failures in large corporations have led some specialists to question the reliability of audits. Too much confidence is given to auditors to discover fraudulent creative accounting practices. While it is claimed that the auditors are supervisors and not hooks in the financial reporting process, they continue to play an important role in ensuring that these errors are minimized.

In this scenario, bankers should be aware that management is primarily responsible for presenting the financial statements. Therefore, it is not a bad idea to study why these companies are doing creative accounting and to study the logic behind this requirement in order to identify potential candidates.

5. Conclusions. Why we must look beyond the figures presented in the financial reports

Since we do not know in advance which companies are publishing misleading information, it is prudent to be suspicious of all companies so they can detect early warning signs. We identified 3 such signs to identify potential candidates:
(i) Poor control environment (the lack of a competent internal auditor, the lack of independent board members)
(ii) Management faces extreme competitive pressures
(iii) Administration is known or suspected of having questionable characters.
Bankers should pay particular attention to these signs in fast-growing companies, whose real growth is slowing, in companies struggling to survive, and newly formed companies.
Therefore, it is important for the analyst to pass through relevant notes and reach an adjusted financial set. In the case of the balance sheet, adjustments need to be made to increase its relevance, such as the addition of off-balance sheet assets or liabilities and the measurement of all assets and liabilities at their current value, etc. Contingent liabilities and assets require a comparison of net worth value and cash flow.

Standard & Poor periodically identifies accounting areas that require analytical adjustments in order to allow for a better credit risk assessment. The December 2004 issue of corporate review in South and South-East Asia highlighted some potential issues associated with comparing the financial analysis of companies adopting different accounting practices. In order to determine the economic and financial health of banks' clients compared to a similar group, the points below are some of the key areas where current flexible accounting standards could hamper an effective analysis, especially at international level:

- operational leasing
- performance guarantees or post-sale bonds
- potential debts after litigation solving
- reported earnings
- the private practices that companies can use in order to boost or ease profits may include:
- different revenue recognition practices
- costs and expense for capitalization policies
- adjustments, such as the revaluation of assets

An adequate financial analysis in a credit or lending proposal should focus on the adjusted balance sheet and on the normalized earnings situation rather than on the P & L and on the common balance sheet. Cash flow analysis is another critical area because it is subject to a lower level of manipulation.

Given the spatial constraints, the importance of the cash flow analysis in credit risk management is not discussed in this research paper, but it should be noted that "cash" is the one that pays off our debts, not the accounting profits.

6. Bibliography

[1] **Amat, O , and Gowthorpe, C.** *"Creative Accounting: Nature, Incidence and Ethical Issues"* Journal of Economic Literature.

[2] **Allen, L. and Saunders, A**., *'Bank Window dressing: Theory and Evidence.'* Journal of Banking and Finance, 16: 585-623, 1992

[3] **Davila, A., G. Foster**, *Management accounting systems adoption decisions: Evidence and performance implications from early-stage/startup companies*. The Accounting Review (October): 1039-1068, 2005

[4] **Dobroţeanu L., Dobroţeanu C.L**., *Audit – concepte şi practici: abordare naţională şi internaţională*, Bucureşti, Editura Economică, 2002

[5] **I.S. McCarthy,** *Hosting Offshore Banks: Benefits and Costs*, IMF Working Paper No. 32, Washington, FMI, May 1979

[6] **Naser K**., *Creative accounting: its nature and use,* Editura Prentice Hall International, Londra,1993