

## A BRIEF ANALYSIS OF CREATIVE ACCOUNTING

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### Abstract

*Creative Accounting is an Anglo-Saxon concept that describes communication practices and techniques, often at the limit of law and lawlessness, where the information in the financial statements is adjusted by professional accountants so as to satisfy the interests of their users. The positive aspect of creative accounting (exploiting the gaps in accounting standards and norms to provide solutions to existing problems) is diminished by accountants who use their knowledge to manipulate accounting information on which the position and performance of the entity are valued. The link between creative accounting practices and business decline has been highlighted by the numerous economic scandals that have led to flawed bankruptcies.*

*The objective of this research is to identify creative accounting techniques and the risks of using them in the context of overcoming the limit between legality and illegality. In order to realize the present article, I will use the theoretical documentation, based on the specialized papers that exist at international level, but also on an empirical research based on the studies of the big bankruptcies of the international companies that used creative accounting techniques.*

**Keywords:** *creative accounting, risks, economic scandals, bankruptcies*

**JEL Classification:** M41

### Introduction

Nowadays, the international economic and social environment is confronted with phenomena that transform the science of accounting, modeling it and perfecting it continuously in order to respond to the interests of the public. Market development and the globalization of economies, the emergence of multinational and cross-border companies, the easy transformation of capital from one form to another and its rapid mobilization for investment activity are just some of the processes that have led to major changes in the way through which the accounting meets the information requirements of the moment.

In this context, the 20th century was marked by the importance of the professional accountant's role in the development of world economies; a quality accounting information being essential to meet the public interest and the collective welfare of the community. However, accounting information does not always succeed in performing the functions assigned by regulatory and accounting normative, the best evidence being the multiple financial scandals followed by resounding bankruptcies [Nicoleta-Cornelia, B.S. et al., 2012] .

One of the causes identified by the authorities to explain the failure of some business that was considered stable (up to a certain point) was the use of techniques for position and financial performance manipulation, techniques known in the literature as creative accounting.

## **1. Research methodology**

In order to accomplish the present scientific research, the main source of information was the study of the specialized literature in the field of creative accounting, namely the theoretical documentation of the national and international legislation applicable to this topic. To present the creative accounting practices we conducted an empirical research based on the case study in the second international enterprise. Also, in order to use creative accounting at the macroeconomic level, we conducted a brief analysis based on the study of the situation of Greece.

## **2. Creative Accounting - an Anglo-Saxon invention**

The emergence of creative accounting is placed on the axis of time at the beginning of the last century, "account manipulation is an old accounting problem starting in the 1920s" [Naser, K., 1993] but the term is used for the first time by the British researcher J. Argenti, 50 years later, in 1973, when he demonstrated the link between business decline and handling and billing practices.

The concept of creative accounting has its origin in the Anglo-Saxon economies and this is not a coincidence because there was a favorable conjuncture given precisely by the characteristics of the Anglo-Saxon accounting system: the freedom of the accountancy profession to use accounting reasoning, the presentation of accounting information to be mainly used by investors, managers' desire to juggle with the result of attracting new capital.

Viewed from the perspective of accountants, the emergence of creative accounting has been facilitated by the existence of basic and alternative treatments used to solve the same problem; most of the time there are two different solutions to the same accounting issue, each way of solving having different effects on the financial position and performance of the entity.

Consequently, it can be said that one of the main reasons for the emergence of creative accounting was the flexibility of accounting rules.

Slowly, the concept of "creative accounting" long used in Great Britain penetrated into the continental accounting system, being taken over by literature under various names: "imaginative accounting", "accounting for intent" or simply "accounting creative".

The pressure of information users, the limits of national and international accounting rules, as well as economic, social and legal development have led to the emergence of global accounting innovation and formed a strong foundation for developing and refining creative accounting techniques [Comandaru, AM, et al., 2020].

The concept of creative accounting is quite controversial in the literature, given that most authors have defined it by highlighting its negative nature: the use of "creative" accounting practices is associated with the emergence of financial scandals and economic crises.

The use of words with negative connotations: scam, manipulation of accounts, and the refinement of results, show the immoral character of creative, not the illegitimate accounting: "Creative accounting does not violate law and accounting rules. It respects the letter, but obviously, not the spirit. There is no doubt about the negative nature of creative accounting. It distorts the results and financial position of the enterprise ... "[Jamerson, M., 1988]. "It is the biggest trick that existed from the Trojan horse ... In fact, this practice is entirely legitimate. It is creative accounting. "[Griffiths, I., 1986].

Over time, there have been authors who "defended" creative accounting; they have argued their opinion by identifying the benefits that financial and fiscal engineering can make: filling gaps in accounting rules, finding optimal solutions to solving accounting problems by resorting to accounting professionals' judgment and experience, logical and natural development of accounting science by introducing creativity in a field that has been considered, until recently, to be rigid and precise.

The evolution of the international economic and social environment has imposed a series of reforms in accounting science, necessary reforms in order to fulfill the role of the professional accountant to satisfy the public interest [Ionescu, C.A., et al., 2020].. Information requirements, changes in the world's economies, the phenomenon of globalization, are some of the reasons why accounting science has become an art, and art involves creativity.

### **3. The temptation to use creative accounting practices**

Globalization of economies is a constant challenge for professional accountants who need to quickly find solutions to the new information requirements, thus requiring the creativity to find treatments that bring an advantage to the enterprise, but without conflict with the law.

Considering the character to the limit of the legality of creative accounting, the question arises why there is the temptation to use these practices.

The reasons for using creative accounting techniques can be synthesized as follows:

- ✎ the conflict of interests and the costs generated by it: if managers are remunerated on the basis of their performance (the company's accounting result) there will always be the temptation to report a higher result;
- ✎ incompetence of management: there are many cases in which the management of an entity has turned to creative accounting practices to mask the difficulties it faces;
- ✎ accounting rules gaps: unclearness in accounting regulations leads to confusion and different interpretations depending on the problems encountered and the expected solutions;
- ✎ the compromise between producers and users of accounting information;
- ✎ the misunderstanding between accounting and tax rules: "Formal aspects (tax substance) are priority to substantive (economic substance) in interpreting transactions and economic events". [N. Feleaga, L. Malciu, 2002]

All of the above factors determine the use of creative accounting practices and have an important influence on the balance sheet and profit and loss account, in the sense of distorting the economic reality.

Positive views on creative accounting point out that without the innovations of professional accountants, reforms in the field of accounting would not have been possible. With the help of creativity, solutions to accounting problems have been discovered that have not been provided in the standards, so it can be concluded that as long as professional accountants act in good faith, creative accounting can fulfill its purpose of finding better methods for solving problems faced by entity management.

The negative character of accounting innovation results, according to the literature, from the fact that only some of the users of accounting information have the advantage of presenting in a certain way the accounting data, so the private interest of some consumers of accounting information prevails over the interest of others and the public interest.

Each category of users of accounting information has arguments for and against the use of imaginative accounting, as follows:

- ✎ investors - are interested in the entity's ability to make profit, interested in earnings, dividends (a artificially increased result would lead to a fictive gain);
- ✎ business partners (customers and suppliers) - are interested in selling products and services and collecting receivables, continuity (an entity that only has "paper" liquidity could affect the activity of its suppliers, and dissatisfied clients may affect the entity);
- ✎ banks and credit institutions - who has an interest in receiving loans and lending on advantageous terms (basing on the information in the financial statements the credit institutions are analyzing the entity's ability to repay loans, some fictitious results could mislead the banks);
- ✎ state - seeks to collect taxes (a lower result involves calculating and collecting a lower tax).

The use of creative accounting is argued precisely by this lack of fairness among users of accounting information. While some gain from certain creative techniques, the same practices bring to others losses. Therefore, creative accounting can't please everyone, and the use of specific practices and techniques implies, above all, assumed risks.

#### **4. The risks and consequences of using creative accounting practice**

The development of creative accounting and its practices has been the subject of numerous papers in the literature of the last decades. Most researchers are of the opinion that the use of innovative accounting techniques is at the border between legal and illegal, between ethical and immoral.

The implementation of creative accounting techniques is achieved through the legal or illegal manipulation of figures and accounting data. It is legally and illegally spoken about the limitation between the two concepts, an easily exceeded limit, a limit which depends on the attitude of the professional accountants who are best placed to observe the skirmishes of creative accounting and who are also the most "competent" to cross this delicate border.

To understand the risks to companies that choose to use creative accounting techniques, we need to distinguish between legal and illegal manipulation of financial statements, between the alternative accounting treatments and methods accepted by law and fraud.

It is precisely in order to mark this easy-going border that the phrase "legal tax evasion" or "tolerated tax evasion" appears in the literature, a phrase which is attributed to the sense of practice by which an entity evades taxes and contributions taking advantage of the gaps in legislation. One can therefore say that tolerated tax evasion is synonymous with creative accounting.

On the other hand, tax evasion (or fraud) should not be confused with creative accounting. "According to law no. 87/1994, republished, as subsequently amended, tax evasion means the stealing by any means from the imposition or payment of taxes, contributions and other amounts owed to the state budget, local budgets, the state social insurance budget and the special funds budgets by the Romanian and foreign natural and legal persons, referred to in the law as taxpayers."

The causes of tax evasion are multiple:

- ✎ legislative gaps that create confusion regarding the way of calculation and payment of taxes, social taxes and social contributions owed by firms to the state budget or the social insurance budget;
- ✎ the frequent changes to tax legislation in conjunction with the voluminous and difficult to understand tax laws;
- ✎ the immoral behavior of taxpayers and professional accountants;
- ✎ poor training, lack of experience or corruption of employees in state control structures, etc.

The above causes give rise to different interpretations of the tax law, leading to erroneous calculations and untrue tax returns. Whether it is ignorance, whether it is bad faith, illicit interpretations of accounting and tax regulations lead to fraud. The legislator identifies and lists the facts that he considers to be forms of tax evasion and draws attention to their criminal nature.

Creative accounting, like fraud, is intentional action, but you can't put the equal sign between the two notions. Creative accounting complies with current legislation but also seeks to exploit its "loopholes", thus contributing to the development of existing accounting and tax rules.

Innovative accounting is legal, fraud is not legal. Applied in good faith, creative accounting techniques can even lead to true image, the same can't be said when legislative loopholes are used to mislead certain categories of users of economic information. In this second case, creative accounting is very close to fraud, even getting to identify with it.

The underlying events of fraud are numerous, among them:

✎ „manipulation or modification of records or documents (forging them to distort or hide the truth);

✎ distorting assets or stealing them;

✎ inappropriate allocation of assets that may lead to a worsening of the entity's financial condition with direct consequences on the continuity of its business;

✎ removing or omitting the effects of transactions in records or documents or recording of substance-free transactions for the purpose of balancing financial statements;

✎ the deliberate misapplication of accounting policies to present misleading financial statements to their users” [L. Dobroteanu, C.L. Dobroteanu, 2002:182].

Tax evasion or fraud and creative accounting are different notions as long as professional accountants put into practice their skills to develop accounting regulations overcome by the passage of time; skills and ... ethical behavior [A.M. Comandaru, S.G. Stanescu, A. Păduraru, 2018].

The importance of financial information is evident in the conditions in which it can influence the evolution of national and global economies. The use of creative accounting techniques has a significant impact on the financial statements reported by the entity in terms of manipulation and distortion of the accounting information.

The risks faced by a "creative" company are numerous and can be classified into three broad categories:

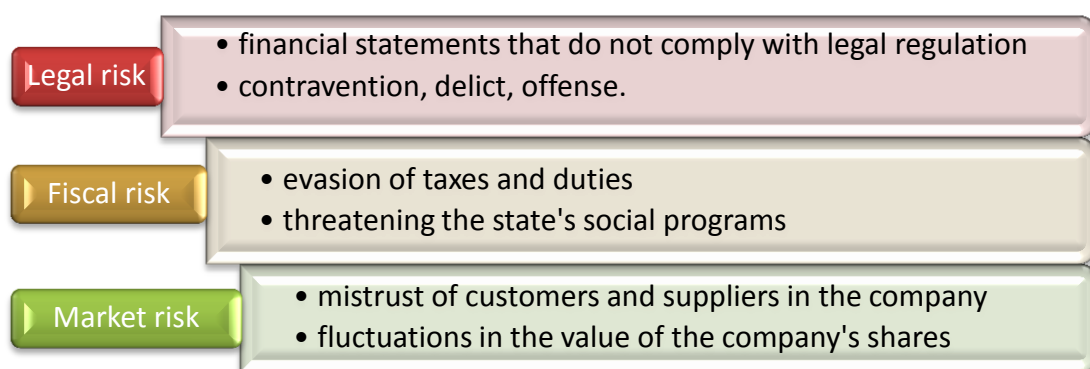


Figure 1: Risk clasiffication  
(Source: own processing)

It may well happen that the assumed risks do not have consequences, but history stubbornly contradicts this statement. Huge economic scandals and disasters quantified in impressive figures are evidence that complements those who condemn the use of creative accounting practices.

The negative influence of the use of creative accounting has said its word in countless cases of financial scandals ended with resounding bankruptcies. It may be remembered about the collapse of the American energy giant Enron, considered the most important bankruptcy in US history, the failure of the Italian company Parmalat, the fourth US investment bank, Lehman Brothers, the US companies Xerox or WorldCom, about the case of Greece reported higher economic performance to join the Eurozone.

In addition, the most resplendent economic disasters that shook the world of business, disasters caused, to a greater or lesser extent, by the use of creative accounting practices will be presented and analyzed.

#### ***4.1. ENRON - the most popular bankruptcy of America***

Considered by Fortune Magazine "the most innovative American company" for six consecutive years, from 1996 to 2001, Enron has achieved tremendous performance: the 7th among the top energy companies with a 25% share of the global electricity market, 22,000 of employees in over 40 countries, huge profits.

In 2000, he reported profits of more than \$ 100 billion and everything seemed to work well within the concern. A year later, on December 3, 2001, Enron declared bankruptcy and announced a quarterly loss of \$ 618 million. The American economy was shaking.

The energy giant, worth 65.5 billion euros, admitted to years of accounting fraud in which he presented the wrong financial statements to the public. The causes of Enron's bankruptcy were numerous, with the company using creative accounting practices to underestimate their debts and to overestimate their earnings, thus maintaining a high rate of quoted shares. In reality, the concern collapsed under the heavy debt burden.

As a result of bankruptcy, US authorities have launched an investigation, Securities and Exchange Commission (SEC) investigating multiple levels of deception and illegal accounting practices. The culprits proved to be the directors who embezzled the company for billions of dollars, but also the investment partners that helped to mask the debts (Enron's debts to banks amounted to \$ 15 billion). Another culprit found by the US authorities was the prestigious accounting, consultancy and audit firm Arthur Anderson who was accused of both negligence in informing investors and destroying an impressive number of documents. For lack of professionalism, the consulting company, one of the most important in the world, member of the Big Five, paid the supreme price, the bankruptcy.

Transpressed into figures, the effects of the disaster have not yet been fully evaluated. An amount of attention attracted me in particular: the exorbitant salaries of company managers reaching \$ 680 million, an extra reason why they used the creative accounting techniques.

Here are some of the "complicated" practices that led to the collapse of the Enron energy giant, namely:

✎ Fair value accounting - Enron was the first non-financial company to use fair value as a method of recording and evaluating long-term contracts, under the pretext of reporting market value.

✎ Special Purpose Entities - Enron's energy giant has created a large number of special purpose entities or offshore companies in order to hide their losses and avoid taxing, but also to get financing from the capital market.

✎ Corporate Governance - Although it has developed a complex system of corporate governance and created a real clutter of intermediaries, Enron managed to fund its activities with the help of special purpose entities that allowed direct borrowing from external creditors. Thus, using creative techniques, the company managed to hide its failures, and even to turn them into financial performance and maintain the price of shares at unreasonably high levels.

✎ Executive staff remuneration - Besides exorbitant salaries, Enron managers also enjoyed other remuneration advantages, including receiving stock options of the concern.

✎ Risk management was a priority for many users of accounting information provided by the US company, Enron being even praised of its risk management system. But this system was also cosmetic. In view of the specific nature of the US concern, Enron could face the risk of price volatility. In order to counteract the effect of price instability, Enron used the special created entities it owned and concluded long-term contracts at fixed prices. It seemed to transfer the risk of offshore transactions, but in reality, it was only to keep those risks inside, which were, among others, one of the causes of bankruptcy in 2001.

✎ Financial audit - following the investigation by the US authorities, Enron has been able to mislead investors as long as they have been helped by business partners, including the prestigious

audit firm Arthur Andersen, a member of the Big Five. The consulting firm has allowed the use of accounting practices by which Enron managed to hide billions of dollars in debt to investors.

Other accounting and equity-pricing practices - the US concern has hired numerous authorized accountants who have worked with FASB (Financial Accounting Standards Board). The role of accounting professionals involved with Enron was to identify the US GAAP regulatory gates so that the US company would be advantageous.

#### ***4.2. PARMALAT - "Enron" of Europe***

The Italian company Parmalat was founded in 1961 by Calisto Tanzi, a 22-year-old entrepreneur in the city of Parma. Since the 1970s, Parmalat has grown a lot, both domestically and internationally, becoming one of the world's leading dairy and bakery manufacturers. The increase in profits was spectacular: from 23 million in 1975 to over 460 million in 1986. Past and subsequent figures are undisputed evidence of the evolution of Italy's small milk preserving facility: in the 1990s, Parmalat was over 36,000 employees throughout the world and operating in 31 countries on 6 continents also had 5,200 dairy farms, of which only 200 are outside Italy. It is worth noting that the prestigious Italian firm has always been controlled of the Tanzi family (which held 52% of the shares) and was run "in the style of Italian affairs," only three executive directors out of 13 were independent, the rest being familiar and close family members.

The company's development was mainly driven by loans, so between 1998 and 2000, the Italian concern acquired 25 companies around the world. One of Parmalat's greatest achievements was the entrance into the North American market, making it possible by acquire Eurolat with a fabulous amount of 400 million euros. Tanzi's dream became reality in 2002 when half of the milk sold in New York was Parmalat milk, and in 2002, the Italian concern reached its peak, with revenues of 7.6 billion euros. In mid-December 2003, Parmalat declared bankruptcy.

2003 was a black one in the history of Parmalat: first, at the end of February, the bond issue of EUR 300 million failed on the capital market as a consequence of the lack of transparency of the issuing company; then, on March 6, 2003, Parmalat presented a fake document certifying the existence of a EUR 4 billion deposit at the end of 2002 at Bank of America in Bonlat Financing Corporation, a branch of the Italian concern in the Cayman Islands (fiscal paradise). Fake detection was made in December 2003 when Bank of America denied the existence of Bonlat's deposit, although the amount of 4 billion euros appeared in the Parmalat balance sheet. The Tanzi family admitted the fake (the document dated March 6, 2003 was only a xerox overlapping the Bank of America header) and because it failed to find a new investor in time, Calisto Tanzi resigned from Parmalat's leadership.

The collapse of the empire created by the Italian entrepreneur has come up with a lot of negative consequences: the Italian economy has fallen by over 11 billion euros (about 1% of GDP), more than 100,000 investors have been defrauded, loans over 14 billion euros left uncovered, thousands of people have lost their jobs and the list can continue.

Parmalat managed to avoid total disaster and, with financial support received from Italian governmental authorities, was re-located at the Milan Stock Exchange in 2005. The resumption of the activity was successfully accomplished, the performance of Parmalat - 4.5 billion euros in 2011 - making it one of the largest companies in Italy and the world. Calisto Tanzi has paid for the fraud committed with a 10-year prison sentence. The Tanzi family is no longer at the head of Parmalat, currently owned and managed by the French group Lactalis.

#### ***4.3. GREECE - creative accounting at macroeconomic level***

Greece, member of the European Union from 1981, has confirmed suspicions about "cosmetisation" of macroeconomic indicators, made for the purpose of becoming a member of the euro area on 1 January 2001.

In order to become a member of the euro area and to enjoy the benefits of this status, Greece has used creative accounting techniques to mask the financial results achieved. Unlimited access to the European Union market, a stable currency - the euro (the second in the world after the US dollar) and the possibility of setting up branches of Greek firms across Europe, are just a few of the privileges that Greece enjoys as a member of the European Union and the area euro.

Greece has reported macroeconomic indicators "cosmetized" to fulfill the convergence criteria for the euro, especially budget deficits, external debt and GDP.

The mechanism used by the Greeks was a legal one or at the limit of legality, and required help from outside the country. The aid came from the American investment bank Goldman Sachs, who, in exchange for a consistent commission, supported the Greek government in trying to bypass the rules of the Maastricht Treaty. Increasing the deficit above the 3% of GDP limit and external debt above the 60% of GDP threshold would have made European Union fines for the Greeks, and that is why the Greek government has turned to creative accounting techniques.

Eurostat has repeatedly drawn attention to the fact that the deficit reported by the Greeks is much lower than in reality. In 2002, Greece reported a deficit of 1.2% of GDP, but the revision was 5.2%. In 2009, Greece's real deficit was 12% of GDP, but this year the Greeks also claimed that they did not exceed the 3% of GDP threshold. In response, the European Union did not see and avoided applying the sanctions provided for in the Treaty.

The exit from the Euro's zone is not an option either for Greece's economy or for the European Union's economy, as it would have far more serious effects than those produced by the cosmetics of Greece's macroeconomic indicators.

Europe's choice to tolerate Greece's creative practices has sparked controversy and even misunderstanding among Member States, especially since this tolerance has been corroborated with the financial support needed to support Greece's economy.

These three examples, I consider, are representative of how dangerous creative accounting practices can be and the negative impact they can have on the economy. Finally, one can conclude: Creative accounting is a weapon that can become lethal if it falls into the wrong hand. These three examples, I consider, are representative of how dangerous creative accounting practices can be and the negative impact they can have on the economy. Finally, one can conclude: Creative accounting is a weapon that can become lethal if it falls into the wrong hand.

## Conclusion

The phenomenon of globalization, as well as the complexity of economic reality, has increased the importance of the role of information in substantiating decisions. Creative accounting has emerged precisely in response to the increasingly complex demands of economic life. Reanalyzing the definitions of creative accounting in specialized literature over time, I can conclude that using creativity in accounting is not a violation of legal provisions, moreover, it is an imaginative exercise of professional accountants who, if they are well-intentioned, offer innovative financial, legal and economic solutions, by exploiting gaps in standards. This is the positive view of researchers on creative accounting.

On the other hand, researchers also noted the direct link between business decline and creative accounting practices, with the negative connotation being deduced from misleading external users of accounting information.

As a general conclusion we can say that it is very important to know the practices of creative accounting in order not to exceed the limit of legality.

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