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Research paper

Creative accounting - innovation or fraud?

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Abstract

The aim of this article is presentation of typical issues that concern definition and interpretation of the nature of creative accounting, and also difficulties faced with differentiation between creative accounting and book-keeping fraud. Historical and contemporary views as well as own interpretation of creative accounting have been proposed.

Keywords: *Accounting; Aggressive; Creative; Fraud; Innovation.*

1. Introduction

Nowadays, the word for „creativity" in relation to accounting is very popular. Revelation of bankruptcy of Enron Company severely tarnished no longer then stable reputation of creative accounting and opened new debates over its character. Since its beginnings, creative accounting has not been winning approval, and it has even been identified with fraud. However, there is a borderline between fraud and creative accounting, which is still arousing a bitter controversy. An abundance of discordant opinions about creative accounting, which is attracting adherents equating it with fraud, and also its defenders standing up for creative accounting as innovation, has been formed.

2. Origin of accounting

Beginnings of accounting date back as early as to Ancient Egypt, Greece, Rome, and Babylon too. It was exactly in those towns, where archeologists unearthed tokens, that is clay disc-shaped counters used for economic settlement of accounts between employee and employer. As payment for one's work, an employee received a token, which s/he could exchange for a symbol etched in it (most often ores or animals). [D. Schmandt-Besserat 2007, pp. 2-4] Growth of trade relations in the Middle Ages led to necessity for development of accounting. Those was not only settling of accounts between an employer and an employee any more, but debt register between a debtor and a creditor. Initially, a debit account existed, but over time also an asset account was gradually kept. Thus, an original merchant's book, which was the form of single-entry book-keeping, came into being. Trade relations became increasingly extended, which resulted in the necessity for emergence of double-entry book-keeping, also dubbed the Venetian system. Back then Luca Pacioli created a highly valued and esteemed work entitled "Summary of arithmetic, geometry, proportions and proportionality". An exhaustive treatise described rules of double-entry book-keeping and is treated as beginnings of dualism. A method of preparing the income statement, trial balance sheet, balance sheet and inventorying. Subsequent years brought further changes, which caused to originate the French Commercial Code. It imposed an obligation upon merchants to keep account books and take stock biannually. In later years, the income statement was introduced too. Nearly 140 years later, a new code modeled on its predecessor, in which a particular attention was paid to insolvency law, was written. By analyzing the Napoleonic Code it is not difficult to notice features resembling contemporary accounting. [A. Staszel 2014, s. 128-129]

3. Essence of accounting

By its broad definition, accounting denotes the system collecting, processing and presenting data (expressed in monetary measure) on financial standing of the enterprise. The system of registry of operations and economic activities, which have occurred in the unit in the fiscal year. Thanks to it, acquisition of a coherent image and condition of the enterprise presented in the financial statement is possible. Accounting may be divided into financial, management and tax accounting. [E. Walińska 2016, pp. 22-25] Financial accounting provides information mainly for external clients, such as investors, contractors, banks. As opposed to the aforesaid, management accounting delivers information to internal users, that is principally for the Management Board's needs. In turn, tax accounting is chiefly kept for the purpose of tax settlements. Accounting is very often mistakenly identified with book-keeping. Accounting is a broader term compared to book-keeping. Book-keeping, next to cost accounting and financial report is a constituent of accounting. [B. Micherda 2006, pp. 18-19]
Accounting is considered the oldest among economic sciences. Its dynamic growth against the backdrop of other economic sciences would not be possible without respecting fundamental rules. A particular fundamental principle is a rule of dualism, according to which sum of assets is equal to total liabilities (equity). Registry based on the Debit-Credit principle enables to understand how operations act on the company's assets and capital. Abstract nature of capital, defined as capacity for performance of work, follows from this principle. It means

that assets of economic unit are recognized as double: in the form of value of assets and corresponding capacity for performance of work. The result of applying this principle in economic unit is the statement, called the balance sheet. It may be illustrated with a practical example of the manufacturing company. We assume that the owner possesses a production machine valued as high as PLN 500.000.

ASSETS = CAPITAL

Production machine (500.000) =? (500.000)

There occurs a situation, where arises a question what the capital is. It cannot represent assets because the machine as their element is placed on the left side of the balance sheet. Equity value positioned on the right side is an abstract, potential yet measurable capacity for machine's operation, that is possibility of manufacturing of products. [J. Renkas 2016 pp. 284-286] This means that equity is inextricably linked to the process of work. This system functions through co-operation of equity as a potential category and work as a dynamic category, which initiates the process. This process consists in transferring the equity to work facilities. An employee has to acquire a suitable level of skills in order to perform a job, during which s/he gains professional experience, thus increasing value of intellectual capital. In practice, this might be e.g. a doctor, who in the course of his studies acquires a suitable level of intellectual capital, which is knowledge. Then, in the process of performing one's work, the doctor's human capital is oriented to work objects, thanks to which he gains experience, at the same time augmenting his intellectual capital. Work is measurable and makes equity measurable too. Thanks to accounting and its principles we can pay attention to the fact that equity cannot arise from nothing. [J. Renkas 2017, pp. 1-2]

4. Functions and principles of accounting

In economic practice, accounting has three key roles to fulfill. All these functions must be served concurrently and are equally relevant due to their effect upon decisions taken by economic entity. We can differentiate: informative, control and analytical functions. Informative function supplies critical information necessary for making a decision to the management and the entity's board. This information can also be utilized by external institutes, such as treasurer's offices, banks, statistical agencies. Control function establishes and archives accounting records, which pertains to business assets and its achieved outcomes. It safeguards against hazards such as economic crime, mismanagement or abuses. Analytical function enables an ongoing or periodical evaluation of activity in unit through interpretations of financial analysis. Indices are then evaluated, thus providing a portrayal of financial situation, assets, profitability and cash flows. [B. Padurek 2012, pp. 3-4]

Accounting principles are divided into three groups: universal, basic (superior) and detailed (inferior) principles. Universal principles are commonly practiced all over the world, irrespective of political and economic system. These include:

- Principle of double-entry (double-sided) – principle of dualism,
- principle of periodization.

Basic principles (superior) define norms of keeping the books of account for the purpose of preparing the financial statement. Principles are the following:

- the going-concern principle,
- the accrual principle,
- the continuity principle,
- the prudent valuation principle,
- the 'substance-over-form' principle,
- the materiality principle,
- the principle of a true and fair view.

Basic principles (inferior) play the role of clarifying the remaining principles. They have a direct effect on the quality of a drawn up financial report. Basic principles are:

- the principle of comparability,
- the principle of impartiality,
- the principle of documentation,
- the principle of completeness,
- the principle of transparency,
- the historical cost principle (asset valuation based on)

Familiarity with these principles is obligatory to all economic entities, which keep records using accounting books and prepare financial statements. [B. Micharda 2016, pp. 26-28]

5. Creative accounting from a historical perspective

First terms for "creative accounting" emerged in the 70s of the 20th cent. They were used in articles and dissertations on bankruptcies of enterprises. It was depicted with negative overtones, defined as a deliberate accounting policy designed for deceiving shareholders and investors. Back in the day, it did not enjoy as high popularity as it gained a decade later in Great Britain. It became a trendy synonym for financial embezzlements and was treated as the perfect crime, due to its legal nature. Originator of this view was the journalist – Griffith, who in 1986 compared creative accounting to the Trojan Horse. It was not hard to guess that a theme of the Trojan Horse with reference to creative accounting is not a positive comparison, it arouses anxiety and mistrust as the Trojan Horse is a symbol of ruse, which apparently seems to be harmless and innocent. [A. Staszel 2019 pp. 109-110]

6. Contemporary creative accounting

Creative accounting is an equivocal notion and very often identified with dishonest conduct, and even swindle. Character of creative accounting is a moot point in the realm of accounting and finances. Three main theories of creative accounting have been developed; part of scholars identifies it with fraud, another with innovation, and the rest claim that its character is ambivalent.

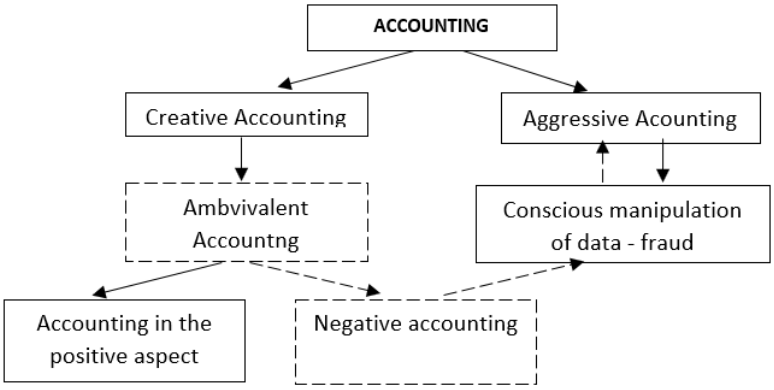

Fig. 1: Accounting Breakdown. (Source: Personal Elaboration).

Creative accounting has become a widespread phenomenon in recent years. Identifying it with a negative phenomenon ensues from putting it incorrectly on a par with unlawful action. Advocates of this view can argue for their thesis with the fact that financial statement recipients are misled by a misrepresented image of financial standing and assets of the entity. At this point, it is worthwhile to underscore that the main quality of accounting, that is reliable and accurate representation of the real image of business will never be fully acknowledged to be objective. This is due to the fact that both reliability and faithfulness of this data is dependent on accountant's efforts and will. [A. Hołda 2016 pp. 45-46]

The idea of creative accounting is present in many countries, but not everywhere is understood the same way. In some areas, notions of "manipulation", "fraud", "creative accounting" are used interchangeably. Creative accounting has also a great number of defenders, who consider it a positive phenomenon. Substantial differences in interpretation of creative accounting have led to isolation of the concept, which presumes that creative accounting is ambivalent, and which then denotes that depending on intentions, creative accounting can have its positive and negative aspects. Positive aspect of creative accounting is recognized as lawful acts, and which is aimed to maximize entrepreneur's benefits by taking advantage of gaps in legal regulations. E. Maćkowiak 2015 pp. 144-146] A negative aspect of creative accounting involves actions on the verge of legality or contrary to the law. It is equated with fraud. Also, a situation when an accountant, by including operations inconsistent with reality and actual state in one's books of account commits a so-called "legal offence" is deemed a negative aspect of creative accounting, because owing to the right of free action s/he is guided by own intentions in order to present better results of business. Such measures are unethical, therefore they carry a pejorative undertone. [V. Lakis,A. Masiulevičius 2018 pp. 46-47]

In my opinion, creative accounting of ambivalent nature blurs the border between good and improper creative accounting thus imposing it a pejorative character. I am an advocate of division of accounting into creative and aggressive, thanks to which this line of the law is more distinct, creative accounting does not lose its approving nature, and fraud is attributed to aggressive accounting. According to the Polish dictionary creativity is an aptitude for creating something new. It is easy to notice that definition of creativity is more approximate to the concept of innovation, which is described by the Polish dictionary as bringing novelty into use. Innovation of creative accounting consists in registering in accounting books as most reliable entity's situation as possible. To sum up, creative accounting should be understood as a reliable presentation of economic events using principles and methods of accounting in a creative manner. It means that use of creative accounting is keeping books in conformity with effective regulations, which are interpreted in a way not directly laid down in these laws. These are lawful acts, hence equating creative accounting with fraud is incorrect. Creative accounting of innovative nature should be identified with creative accounting, whereas its negative aspect, that is in other words fraud should be ascribed to aggressive accounting.

In order to understand the meaning of aggressive accounting, it is worth beginning with defining a term of aggressiveness, which is interpreted by the Polish dictionary as activities taken up to gain desirable values and actual states. Thus, an image of aggressive accounting is developed as willful and intended keeping of accounts and rules of law, which significantly have a (harmful) effect upon the outcome of accounting, which is financial statement [P. Gut 2006 p. 11] One of the main signs of aggressive accounting may be common changes to policy of accounting. Mergers and takeovers of companies often make it possible for dishonest dealings. In the event of a fusion, benefits are taken into consideration, that is growth in value of combined entity in relation to value of each separate entity. High profit improves an image of the company, bringing about an apparent effect of development. As a warning signal against aggressive accounting are disproportionately high prizes for the board of managers, lack of knowledge in the field of accounting, members of supervisory council, complex organized structures, numerous restructuring reserves and also additional information prepared in general terms. [E. Śnieżek 2016 s. 141-142] Frauds are not a new occurrence, they exist as long as accounting does. Possibilities of their commission took place already in the very beginning, that is from the first statement of affairs. Benedictine monk Angelo Pietra already in the 16th cent. in his work described the way discretionary changes increasing or decreasing value of estate were made before final balance sheet. Not much has changed nowadays. Willingness to present an outcome in a better or worse light has developed a few methods for "embellishing" financial statements. Reasons for perpetration of frauds are among others:

- Greed,
- Human's egoism,
- Absence of professional ethics,
- No sense of responsibility,
- Image of the company,
- Pressure of rising to challenges of the market, owner, creditors,
- Personal profits,
- Complex organizational structures,
- Conflict of interests between the owner and the managerial board;

Identification of activities related to aggressive accounting is very difficult and complicated in the case when entity has reached a high rank on the market exactly by committing dishonest practices and embezzlements. [M. Tokarski 2008 s. 282-283]

7. Disparities between creative and aggressive accounting

The reason, due to which problems related to differentiation creative and aggressive accounting occur, involves practice of accounting policy, which ensures right to choice of some solutions. These solutions must be pursuant to national and International standards of accounting. In practice, such actions are very frequently regarded as acting for one's own benefit, through which properties adequate for aggressive accounting are accorded to creative accounting. Furthermore, financial scandals, which are hyped by media upset an already rickety balance between these two phenomena. [K. Dziadek] An attempt was made to define creative accounting in the scholarly environment. It was a ground-breaking moment, thanks to which creative accounting won a circle of its followers, recognizing it as a positive and lawful phenomenon. At this time, there appeared a division of creative and aggressive accounting, which was originated by prof. dr hab. Elżbieta Mączyńska, thanks to which already in 2002 this division was applied. However, there is one more destined group of people, who identify them with themselves, in spite of utterly different functions of both domains of accounting. [E. Maćkowiak 2015, p. 145] Aim of creative accounting is exercise of law (and areas of freedom) resulting from Statute on Accounting, International Financial Accounting Standards and other legal acts regulating the accounting. In case of aggressive accounting, its purpose focuses on taking advantage of gaps in rules of law in order to achieve financial benefits. It arises from the fact that as opposed to aggressive accounting, actions related to creative accounting are lawful actions. Another difference is impact on financial outcome, since in case of creative accounting, a financial result represents an entity's real (financial) state of affairs, whereas as regards enterprise practicing aggressive accounting, the financial outcome is distorted. Creative accounting is applied by means of principles of accounting, whereas aggressive accounting features more methods, among which we can include data manipulations, embezzlement, overstating/understating of profits, deliberate misinterpretations of gaps in legal framework or concealment of losses.

Both types of accounting produce opposite effects, in case of creative accounting an effect is financial report prepared based on principles of accounting, whereas in case of the latter one needs to take account of insolvency, bankruptcy and criminal liability.

Every entrepreneur running an economic activity is obliged to conform to accounting policy. This entails the right to choose some solutions, so that they could be compliant with national and International accounting standards. However, in practice such actions are very often identified with acting for one's own benefit, which results in attribution of negative qualities of book-keeping frauds to creative accounting. In addition, scandals publicized by media cast a shadow on creative accounting.

8. Conclusion

Definition of creative accounting is still a disputable matter in literature, and issues of its comprehension have not yet been clarified. Several interpretations of creative accounting can be found. The first one defines creative accounting as fraud and crime. The second one interprets accounting as phenomenon of ambivalent nature, which means that depending on intentions it can be positive or negative. In my opinion, creative accounting is an innovation, which is a positive occurrence and has nothing in common with deceit. Fraud needs to be ascribed to aggressive accounting, which as the very name suggest carries a negative undertone.

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