Emerging Markets Queries in Finance and Business

Manipulating user behavior through accounting information

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Abstract

The financial reporting based on accounting principles should give a true and fair view of the business reality. But sometimes, the accounting information is handled; therefore users’ behavior is manipulated. The accounting managers, who control the form and content of the financial statements issued by corporation, will make sure that these portray a picture that is favorable to them. The main objective of financial reporting must be to provide valuable information to users. So, when deciding the content of the financial statements, the information needs of the users should be taken into consideration. These needs may be assessed by analyzing their decisions for which the accounting information may prove to be helpful. In this study we analyze the techniques used for the manipulation of accounting information and we propose different solutions in order to mitigate them. The paper also presents an overview of the concept – although an exact definition was not established so far, many authors tried to give an explanation for this phenomenon.

Keywords: creative accounting; accounting manipulation; fair presentation; financial reporting;

1. Introduction

An irony of our times may be that although hundreds of satellites monitor the planet, although we see a widespread use of information technology, allowing the collection, accumulation, transmission and processing of an impressive amount of data, still the accuracy of economic and financial data reporting remains dependent

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to the referential reporting data and the “handling” techniques of the results. Despite multiple sources of information, at the same time, the reflection of financial accounting information remains the main source of economic activity and the result of these activities for both, entities and their managers and even for the great diversity of third parties: suppliers, customers, employees, investors, banks state institutions, etc [1].

Although it is sometimes considered science and sometimes art, accounting has managed to gain reliability in the economic world. The ones that do not understand it, can easily imagine that accounting is a very exact science, similar to mathematics. In reality, the accounting information is neither simple nor precise and rarely meets all requirements of the various users [1].

2. General considerations on creative accounting

Accounting can be considered as representing the company's life, based on principles, norms and judgment. The purpose of the enterprise accounting representation is the preparation and presentation of annual financial statements, which should provide the users of accounting information, a more accurate picture of activity. However, there are plenty of situations where users can be influenced one way or another, by presenting distorted accounting images and thus their behavior can be manipulated. Introducing artificial accounting images increases the information asymmetry and influences the functioning of financial markets [1].

In this respect, the FASB (Financial Accounting Standards Board) states that: “The information provided by financial reports is often the result of approximate rather than precise quantification. Quantification usually involves numerous estimates, classifications, integrations, reasoning and systematization. Product business in a dynamic economy is uncertain and results from a combinations of several factors. Thus, despite the impression of precision which creates financial reports, with few exceptions, quantification is approximations that may be based on the rules and conventions rather than exact amounts.”

As a result of the uncertainties inherent in the activities, many financial statement items cannot be measured precisely, but they can only be estimated. The estimation process involves judgments based on the latest available and credible information. For example, estimates may be required in relation to: bad debts, stock’s moral depreciation, the fair value of financial assets and liabilities, the useful life of the asset and the expected pattern of consumption of economic benefits for depreciable assets, liabilities arising from guarantees, and so on.

The specialized press has shown a series of cases of handling user behavior through dissimulated accounting information which ultimately ended with major financial scandals. Examples include: energy company Enron, which went bankrupt soon after discovering irregularities in December 2001 (the firm dissembled a total amount of 27 billion U.S. dollars), the telecommunications company WorldCom, which has inflated cash flow with almost 4 billion U.S. dollars and the discovery of financial fraud of global manufacturer of copiers Xerox (in July 2002) that illegally increased its turnover with approximately 2 billion U.S. dollars in 1997-2001.

According to latest research, the management of these companies was very well informed about the real situation and moreover, large audit firms like Arthur Andersen (now taken over by KPMG) that audited financial statements of the mentioned companies. Along with these financial scandals, it is almost natural that the investors’ and other users’ confidence fall apart. Even if accounting manipulations do not involve cases of bankruptcy, they will surely have a certain future effect - low credibility of information will lead to additional costs in future periods (loans with higher interest rates, for example). We might consider that this entire situation occurred because nowadays, appearance seems to be more important than real existence. In this context, accounting can be referred to as “the salesman of economic performance for the enterprise” [2].

Over time, accounting has been treated as an art – “the art of fake or trick stock” [3], “the art of calculating benefits” [4], “the art of presenting a balance sheet” [5], “the art to create provisions” [6]. “Engineering accounting” is a less common word in literature, it is usually titled creative accounting and it is subject to a vast literature in the past 20 years. The use of this concept shows a possible association with creative work, design,
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