

## **The Accounting Framework and the Financial Information Management**

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### **Abstract**

The present article aims to emphasize the impact of the accounting framework on the financial information management. Being a very wide theme, it is natural to be taken into consideration only several aspects, an exhaustive point of view not being possible. Thus, there are analyzed the reasons why the decisional factors resort to creative accounting practices and their effects on the main financial statements of the companies. In order to give a practical feature to the work, a concrete example will be presented.

**Keywords:** accounting framework, reasons, financial statements, financial information, management

### **Introduction**

Creative accounting is considered a real "apple of discord" among specialists. Thus, the specialized literature has managed to draw two wide categories of accounting policies. These policies are translated, either by an imaginative accounting, in order to exploit any legal vacuum through various methods and techniques of accounts' improvement or by an intent

accounting that provides accounting, as a science, with the possibility of keeping up with innovations in the area of the financial tools and policies.

While creative accounting policies aim a maximization of profits, or the assurance of a certain autonomy and financial flexibility provided by a minimal binomial return - risk, the creative accounting itself reflects the efforts of the normalizers to align to the financial specialists' requirements. In other words, the internationalization of the financial markets, the dynamics of the globalized markets and the continuous process of globalization, asked the decision factors to build up certain evaluated forms of financing investment policies and of covering the operational needs.

### **Methodology and Data**

In order to accomplish this work, there was necessary to use multiple methods such as: comparative analysis, synthesis, induction and deduction or mathematical modeling.

### **Research results**

Therefore, the accounting has to adjust its rules to the evolution suffered by the economical systems. To correlate the current needs of the decision factors concerning financial management with the legislation in force, in order to be able to make a clear distinction between an unlawful accounting and a legal "reforming" accounting, it is necessary to start from the premises of this phenomenon.

The "yawn" created between the legal accounting framework and the illegal accounting practices could have as main causes:

- the acceptance of alternative accounting treatments of different economical operations, such as the cost of borrowing required by IAS 23 concerning the option of capitalization or reporting to the period expenses of various financing costs associated with an asset's production or acquisition;
- the need of accounting to work with estimations or forecasts within an uncertain economical environment, where forecasts have a mistrust degree, caused either by the tendency of willful manipulation or by attitudes and perceptions of the accounting specialists on value, by update rates or by methods of calculation;
- the lags occurred in the development of finance and accounting environments, generating the impossibility of accounting to reflect the true image of the economic condition of a company,

as long as financial mechanisms such as the securitization of receivables, the issuing of hybrid securities, or deleveraging may not be reflected using the accounting terminology and instruments.

The motivation of the decision factors to resort to creative accounting techniques are numerous and various, covering a large part of the directions pursued by the financial management of the entity recalling in this regard:

- the costs released from the phenomenon of informational asymmetry that exists among the users of accounting information;
- the mandate costs and restrictions, correlated with an acute incompetence of the decision factors in order to find solutions to revive the economic health of the entity;
- the trial to conceal a healthy company, by the „signaling” techniques, related to the dividend policy, the debt policy or the investment one etc.;
- the need for hedging policies using the financial risk instruments, despite the fact that these instruments are still not clearly defined within the current accounting framework;
- the multitude of assessment bases tacitly imposed by the economic and financial particularities, practically endless, which distinguishes the fields of activity between them;
- the conceptual relativism and the professional judgment subjectivism, the arbitration between the need for applying rules, often rigid and the appealing to value judgments;
- the accounting information users’ attitude regarding the relevant indicators in the annual financial statements;
- the doubling of the goal for covering risks using financial derivatives, with a direction of dematerialization of patrimonial substance of the entity by extending financial policies in the operating cycle (speculating with the help of investment securities, homogenizing economic policies by forming consortia, building up joint venture companies), increasing the efforts to shift to a knowledge and brand based management (increasing the share of patents, licenses and trademarks).

The possibilities of fructification of the breaches occurred within the national and the international reference accounting framework, in terms of ensuring the compatibility of the two ones, it is taken into

consideration either an improvement of the economical situation reflected through risk indicators and financial autonomy (balance sheet), financial balance and liquidity (financing picture), or return and solvency (balance sheet and income statement).

Concerning the balance sheet, we could mention:

a) the deleveraging in fact, that consists of a transfer of assets and also debts to a trust, without changing the legal relationship between borrowers and initial lenders;

b) the revaluation of depreciable fixed assets;

c) the issuing of hybrid securities, which merely question the foundations of the bases for classifying financial securities, however weakened by the passage of time and the current economic and financial evolutions;

d) selling and return practices.

Concerning the income statement, we could mention:

a) the lease-back operation, which consists in selling an asset and taking it immediately on location;

b) the increasing of differences in purchasing, aiming through an undervaluation of the purchased asset, approved by both, the head of department and the auditor, an increase in reserves, as long as the accounting rules allow this fact;

c) the increasing of the collaborators expenses, encountered mainly within the small and medium enterprises, seen as an alternative of the dividend policy;

d) the recording an additional and artificial result from the disposal of an asset, which consists in its settling to the current income of the accounting income obtained, while its collection will appear in a subsequent accounting period;

e) the recording of an ascending production cumulative stored from one month to another, a situation which is rather dictated by an economic context than by an accounting option;

f) the circular transactions practice, which involves the collaboration between two companies, by conducting reciprocal transactions by which to improve their financial situation within the financial statements, because of the differences between input and output of such traded assets;

g) the diminution in receivables loss, which consists of giving up to prudential provisioning policies, in the favor of receivables' insurance, with the obligation to pay an insurance rate; this way, the

entity is able to report the entire value of the receivable, in exchange for a relatively insignificant cost of insurance, considering the spread character of the rate.

Concerning the financing picture, we could mention:

a) the arbitrary classification of financial securities in investment securities or non current securities, taking into consideration the fact that the entity does not know with certainty their finality;

b) the electing and the calculating of the discount rate to the future cash flows, with the purpose of incorporating the financial and the economic risks;

c) the subscribing to insurances, in case of uncertain receivables, case in which there are affected in the same measure, both the lead financing flows and the balance sheet or the income statement; it is important to notice that this operation is similar to the deleveraging technique and that it is a way of covering against the risk of nonpayment.

There are also creative accounting effects arising from the accounting policies themselves, as we could notice the provisioning policy, the policy of depreciation, the accounting of long-term contracts or the conversion of the costs of capitals increase in issuing premiums.

We will consider in this regard, that our entity appeals to the deleveraging technique, in order to transfer to a third party a receivable of 3,000,000 lei, collectable in three annual installments (45% in the first year, 35% in the second year, 20% in the third year) with an interest rate of 10% ( $r_c$ ), and also a debt of 3.500.000 lei, with an interest rate of 5% ( $r_d$ ), repayable in three annual and constant installments.

In this matter, it is questionable the decision of the third person to accept such a "barter" as long as he pursues a future gain, allegedly to be given by the claim superiority of the updated installments of the receivable collected compared to the annual reimbursements related to the debt assumed.

For an annual receipt we have  $\text{Receipt}_{\text{Updated}} = \text{Receipt}_i / (1+r_c)^i$ , where  $i = \overline{1,3}$ . The annual claim to receive is given by  $\text{Receipt} = \text{Receivable} \times p_i$ . Of the present value  $\text{Receipt}_i$  it is subtracted the updated value  $\text{Receipt}_{\text{Updated}}$ , obtaining the interest gained from this operation  $\text{Interest}_{\text{gained}} = \text{Receipt}_i - \text{Receipt}_{\text{Updated}i}$ .

**Table no. 1.** Updated receipt and gained interest

Year	% receipt	Receivable collected	Updating factor	Updated receipt	Interest gained
1	35%	1.350.000 lei	0,8696	913.043 lei	436.957 lei
2	20%	1.050.000 lei	0,8264	495.868 lei	554.132 lei
3	40%	600.000 lei	0,5120	614.400 lei	-14.400 lei
<b>Total</b>		<b>3.000.000 lei</b>		<b>2.023.311 lei</b>	<b>976.689 lei</b>

For an annual receipt we have  $\text{Payment}_{\text{Updated}} = \text{Liability} \times r_d / 1 - (1 + r_d)^{-n}$ , where  $n = 3$ , which is constant for the entire repayment period. The annual payments are calculated according to the relation  $\text{Payment}_i = \text{Liability} / n$ . Of the present value  $\text{Payment}_i$  is subtracted the updated value  $\text{Payment}_{\text{Updated}i}$ , obtaining the interest gained from this operation  $\text{Interest}_{\text{Owed}} = \text{Payment}_i - \text{Payment}_{\text{Updated}i}$ .

**Table no. 2.** Updated payment and gained interest

Year	Updated receipt	Updated payment	Financial result	Interest gained
1	913.043 lei	1.285.230 lei	-372.186 lei	318.393 lei
2	495.868 lei	1.285.230 lei	-789.362 lei	435.569 lei
3	614.400 lei	1.285.230 lei	-670.830 lei	-132.963 lei
<b>Total</b>	<b>2.023.311 lei</b>	<b>3.855.690 lei</b>	<b>-1.832.379 lei</b>	<b>620.999 lei</b>

Therefore, the earnings from the capitalized interest of 620,999 lei, owed to the time value of money is significant, it does not cover the additional cost of 1,832,379 lei that the entity thought the receivable and the debt has to bear from its own treasury. Consequently, conducting such an operation is not taken into consideration.

But, if we admit that also the receivable is collected under constant annuities, than the financial result of the payments will be  $\Delta = \text{Receivable} \times r_c / 1 - (1 + r_c)^{-n} - \text{Liability} \times r_d / 1 - (1 + r_d)^{-n}$ . So we get the value  $\Delta = 3.000.000 \times 0,4380 - 3.500.000 \times 0,3672$ , meaning an annual profit of 28.701 lei, thus a total profit of 86.103 lei.

Obviously, there is an interest conflict, born by the desire of the principal debtor to lower his overall risk with an as low as possible cost, while the third person, who takes over the debt and the debt from the administration, aims to obtain a gain as high as possible from the difference between the gained interest and the owed interest.

We notice that the report  $(\text{Debt/Receivable}) \times 100$  is approximately 116.67%, but not to forget that the difference between the updating rate of the receivable and the debt interest rate is positive, in amount of 10%. The rationality of the financial policy is that this operation emits a profit of 86.103 lei. But much more important is the reduction of the deleveraging level of the entity, which decreases by 0,020%.

If we take into consideration some balance sheet elements, the impact will be the following:

**Table no. 3.** Adjusted financial statements elements

	<b>N</b>	<b>N<sub>adjusted</sub></b>	<b>%</b>
<b>Non current assets – Total</b>	22.253.002 lei	22.253.002 lei	0,000%
<b>Current assets – Total</b>	4.413.732 lei	4.410.732 lei	-0,068%
<b>Debts: sums that have to be paid in a period less than a year</b>	3.561.335 lei	3.561.335 lei	0,000%
<b>Debts: sums that have to be paid in a period more than a year</b>	2.822.317 lei	2.825.817 lei	0,124%
<b>Shareholders' equity – Total</b>	14.056.147 lei	14.056.147 lei	0,000%
<b>Deleveraging rate</b>	0,6329	0,6331	0,020%

Similar is also the case of the lease-back operation, which specifically aims to improve current liquidity of the company, accepting the sale of an asset and its immediate recovery through a leasing contract, which requires costs with the interests broken down over several financial periods. Moreover, such an operation is even more advantageous, as long as it is used as a recovery of the asset way, a location-exploitation contract.

### **Conclusions**

Each imaginative or intent accounting method, exposed above, produces different effects, in various forms, in different sizes within the financial statements. The mission of the Romanian normalizers is to identify solutions in order to limit such practices, considered “intentional legal pollution”, which was built up in powerful tools for

generating economic superior and artificial rentabilities, with much undervalued risks.

These all lead, in one way or another, to the distortion of the true image reflected by the financial statements, by value or structural mutations in the financial structures, or by issuing of false signals and deliberate misinformation, framed by the legal context in force, or by a set of rules that are too rigid, either through an uncontrolled "liberalization" of the accounting conceptual frame.

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