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Possibilities of Cosmeticizing Financial Situations through Accounting Policies and Options – Theoretical and Applicative Particularities

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Abstract: The purpose of the research is to make a foray into the presentation and perception of accounting policies and options possible to be adopted by an economic entity, as well as to reveal their impact on the information provided by the financial statements. In this sense, a theoretical research of the specialized literature and the accounting legislation in force was undertaken, as well as an empirical research in which the comparative analysis method was used, the aim being to demonstrate the implications of the accounting policies chosen by the company on the quality of the financial - accounting information provided by the financial statements.

Keywords: accounting policies and options; comparative analysis; alternative treatments, financial statements; recognition; evaluation; presentation; accounting result; fiscal result

JEL Classification: M41

1. Introduction

Accounting policies represent the rules and methods adopted by the economic entity to evaluate, recognize and present the component elements of the financial statements. Also, accounting policies refer to alternative options and treatments determined by certain interests, but permitted by norms and standards.

The importance of defining accounting policies resides in the need for establishing the criteria according to which there are highlighted in the entity's accounting policy its

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events and transactions. Thus, the development of accounting policies has a direct impact on the quality and quantity of the financial-accounting information reported by the entity and used by stakeholders in the decision-making process.

The formulation of accounting policies is subordinated to obeying the fundamental principles, but it also aims at the presence of freedoms that allow the existence of options through which the entity chooses its favorable accounting methods and treatments for the presentation of the financial position and performance. These freedoms are appreciated by management because they allow the use of creativity in the preparation and reporting of financial statements, but they are also a source of controversy regarding the achievement of the true picture sought in accounting.

The application of accounting policies is based on professional judgment (Răileanu, Manea & Răpceanu, 2009, pp. 64-68) and there are not few cases where, out of a desire to present improved results, the entity resorts to creative accounting techniques to embellish its position and financial performance.

When having to solve the same problem and there are several solutions embodied in different methods and alternative accounting treatments, it is mandatory to present the policies applied by the entity in the explanatory notes of the financial statements. Thus, the relevance and comparability of the financial-accounting information necessary to substantiate decisions is ensured. A remark is required, however: the statement of cash flows is a report prepared independently of the accounting policies chosen by the entity. However, users of financial-accounting information still attach great importance to the level of the result, which requires additional guarantees according to which the entity has not proceeded with accounting manipulations for the purpose of maximizing or diminishing profit. One such guarantee is the audit of the annual financial statements.

2. Literature Review

Naser K., in the work *Creative accounting: its nature and use*, defines creative accounting from an academic perspective as "the process by which, due to the flexibility and existence of gaps in the rules, the figures in the annual accounts are manipulated, the result of the choice of measurement practices and information being the transformation of summary documents from what they should be to what managers want"[5] and he also points out that "manipulation of accounts is an old accounting problem dating back to the 1920s". Even though it appeared more than a century ago, creative accounting practices are current, of interest, especially to managers who resort to embellishing accounting earnings to meet investors' growing expectations of economic returns[6].

Freedom and conformity in a diversity of accounting policies become action by recourse to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.[7]

Definition of accounting policies from OMFP no. 1.802/2014 is in accordance with the one from point 5 of IAS 8. We thus note the harmonization of the Romanian accounting reference with the provisions of IAS 8 regarding the requirements for the reflection and application of accounting policies.

In the 2000s, N. Feleaga and L. Malciu had a significant role in the perimeter of accounting research related to the development and substantiation of enterprise accounting policies, through the book *Policies and accounting options*, published by the Economic Publishing House. The researchers structured their work in two parts. In the first part, the problem of accounting policies and options in the service of *fair accounting* is addressed, presented in the light of the Romanian accounting reference and the international accounting reference from that time. In the second part, accounting policies and options are indicated in the service of *bad accounting.* The research of St. Buena embodied in the doctoral thesis entitled *Optimizing the financial performance and the performance of enterprises, between the strategies of conservatism and accounting optimism* (Bunea, 1999-2004), develops a series of analyzes regarding accounting policies and their strategic dimension. In the third part of the thesis, qualitative analyzes and case studies are carried out regarding the sources of pessimism and optimism in the design of accounting policies.

Another significant contribution in the field of research on business accounting policies belongs to M. Ristea. He distinguishes between accounting policies and methods. He specifies that "if accounting policies are options regarding the principles, evaluation bases, conventions, rules and specific procedures adopted by companies when preparing and presenting financial statements, instead, the methods represent the treatments or procedures used by companies in accordance with accounting rules and policies to produce and provide reliable information regarding the financial position, financial performance and cash flows" (Ristea, 2000, p. 9). A. Duțescu (Duțescu, 2002; Duțescu, 2003) tried to sensitize the specialized public regarding the importance that every institution and economic entity must give to the development and foundation of accounting policies. M. Ristea and C.G. Dumitru address in their research a series of issues related to freedom and compliance in a diversity of accounting policies. The two authors define the accounting policies in the spirit of the provisions stipulated in OMFP no. 1.802/2014. But in another vision, they define accounting policies as representing "options determined by certain interests, respecting certain principles, rules and conventions regarding the registration, recognition and evaluation of the elements described by the accounting model, preparation and presentation of financial statements. If these rules become imperative, applicable through legal and regulated texts, the accounting policy is reported and subordinated to *the regulatory system in the field*". N. Feleagă and collaborators (Feleagă & Feleagă, 2008) focus on the role of professional judgment in the development of accounting policies. The role of professional judgment in the development of accounting policies is a decisive one, the financial statements presented to users being the result of decisions taken within the enterprise. The accounting policies adopted by the enterprise represent decisive elements in terms of obtaining quality information, necessary for various categories of users in making decisions.

3. Research Methodology

The systematic realization of the present scientific research aimed at the development and deepening of knowledge in the presentation and perception of ***possible accounting policies and options*** that can be adopted by an economic entity, as well as to reveal their impact on the information provided by the financial statements, the perspective approached being that of fundamental research (theoretical) corroborated with that of applied research.

The fundamental research reflected in this paper is based on theorizing the specific concepts of the chosen topic, namely: accounting policies and options, alternative accounting treatments, recognition, evaluation, presentation, assets and liabilities, accounting result, tax result, deferred tax, permanent differences, temporary differences, debt costs. Also, there are discussed from a theoretical point of view, aspects regarding:

- Meanings in defining the concepts of accounting policies and options;
- Accounting policies and options for recognition, evaluation and presentation in the financial statements of assets;
- Accounting policies and options for recognition, evaluation and presentation in the financial statements of liabilities;
- Accounting policies and options regarding the evaluation and calculation of the result as a dimension of the entity's performance and object of taxation;
- Accounting policies and options regarding the capitalization method and the result method;
- Accounting policies and options related to ensuring the comparability and relevance of financial-accounting information provided to users;
- Cosmeticizing financial statements through biased accounting policies and choices.

The applied research undertaken within this scientific approach aims to highlight the possibilities of cosmeticizing financial statements by adopting tendentious accounting policies and options.

The content of the present paper harmoniously combines specific elements of qualitative research with aspects that involve quantitative research. In terms of qualitative or interpretive research, we proceeded to review the literature in the field with the thought that our scientific findings will be more convincing and accurate if more bibliographic resources are used (Yin, 1994). Thus, we used deductive reasoning to document the researched phenomenon, among the analyzed sources being: specialized books, articles published in magazines and economic journals indexed in international databases, accounting standards and norms, normative acts. We paid the same special attention to the papers written in English, French, but also Romanian because we pursued a more complex approach to the field under research. The sources cited throughout the entire paper have revealed opinions and analyzes of foreign and local authors regarding the phenomenon of abusive use of alternative treatments that can lead to modeling the financial position and performance of the entity, so that the image of the financial statements is manipulated and the beneficiaries of the information provided by accounting are misled.

The quantitative or positivist research addressed in the paper resides in the realization of a comparative study which demonstrates the implications of the accounting policies chosen by the company on the quality of the accounting information provided by the financial statements. It should be noted that the present study is based on three sets of accounting policies with different objectives.

In order to carry out the quantitative research, the following methods and techniques were used:

- numerical exemplification, used to show the different policies and accounting options adopted within the entity;
- tabular and graphic representation, used in the case of showing the results of theoretical and applied research;
- content analysis of the financial reports published by the economic entity;
- comparative and correlative analysis of the results obtained from empirical research;
- case study – comparative analysis – to reflect the image of the financial position and performance obtained by adopting accounting policies with different objectives.

4. Meanings in Defining the Concepts of Accounting Policies and Options

The concept of accounting policies is the subject of numerous studies and researches. In this context, the specialized literature abounds in definitions whose common element refers to the actions undertaken by an entity to report relevant information that accurately presents the economic reality it faces. In other words, the accounting policies must describe how the economic entity has decided to apply the legal regulations ensuring that the reports issued present credible, relevant and useful information about the financial position and performance, taking into account the existence of accounting options and alternative treatments. Accounting policies are regulated by law and represent the principles, bases, conventions and rules applied by an economic entity for the preparation and presentation of annual accounts (Gurău & M.I., 2020, p. 85).

Figure 1 shows the most representative, in our opinion, three definitions of the concept of accounting policies.

ACCOUNTING POLICIES

represent

"The principles, the bases, conventions, rules and the specific practices applied by an entity to preparation and presentation of financial situations" (IAS 8 Accounting policies, changes in accounting estimates and errors)	"Specific accounting bases are used permanently by an organization in the preparation of financial statements; these bases are considered and determined by the organization as the most appropriate for the faithful presentation of its financial results and operations" (Dictionary of Accounting of the University Publishing House from Oxford)	"Options determined by certain interests, respecting certain principles, rules and conventions regarding the registration, recognition and evaluation of the elements described by the accounting model, the preparation and presentation of financial statements", [Ristea M., Dumitru C.G., (2012), Freedom and compliance in accounting standards and regulations, CECCAR Publishing House, Bucharest, p. 32)

Accounting policy set = accounting options

Figure 1. Dimensions in Defining Accounting Policies

Source: personal projection

Accounting policies can be classified into three broad categories:

I. *Accounting policies for the evaluation of elements in accounting* (for example: the principle of evaluating the acquisition or production cost, the evaluation of stocks at the lowest value between the historical cost and the net present value, the evaluation of tangible and intangible fixed assets revalued at the lowest value between the fair value and the recoverable value, the use of the CMP, LIFO AND FIFO method when valuing stocks at exit - with the observation that IFRS do not recognize the LIFO method, the evaluation of real estate investments at fair value according to IFRS or at cost according to national regulations, etc.);

II. *Accounting policies for recognizing items in accounting* (for example: applying the perpetual inventory method or the intermittent inventory method, in the case of stocks, capitalization of borrowing costs, recognition of expenses at the time of consumption or at the time of obtaining income, recognition and correction of errors by reversal chargeback or red chargeback, etc.);

III. *Accounting policies for the presentation of elements in the financial statements* (for example: the presentation of operating expenses, according to functions or nature, the presentation of cash flows by the direct or indirect method, the presentation of income and expenses in the profit and loss account and in the statement of the overall result - according to IFRS or only in the profit and loss account – according to national regulations, etc).

But, according to the literature in the accounting field, the company's accounting policies are also classified according to other criteria, a fact highlighted in ***Figure 2:***

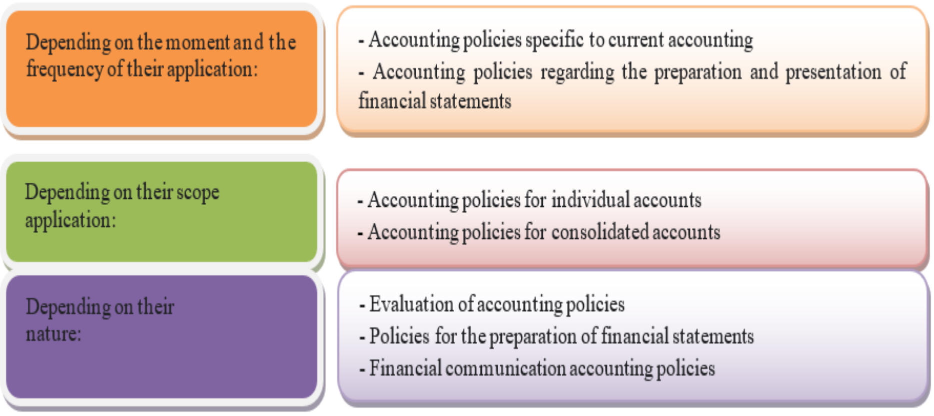

Figure 2. Typology of Accounting Policies

Source: Bunea Ş., (2006), Monocromie şi policromie în proiectarea politicilor contabile ale întreprinderilor, Editura Economică, Bucureşti, pp. 124.

The set of accounting policies adopted by the economic entity represent accounting options, and options involve choices. Under these conditions, accounting specialists consistently choose accounting policies favorable to the entity, professional judgment and regulations in force representing the basis of these options.

5. Accounting Policies – Instrument for Achieving Accounting Objectives

Accounting presents, through the financial statements drawn up by the economic entity, a series of financial-accounting information necessary for users to make decisions. The importance of the provided information attests and confirms accounting's main objective: presenting a true picture of the financial position and performance of the economic entity.

Accounting policies are a tool for achieving accounting objectives because through them the conditions are established that are the basis for the development and recording of economic-financial operations in accounting. Moreover, accounting policies are regulated by national and international legal texts, which oblige economic entities to comply with rules for recognition, evaluation and presentation of assets, liabilities, equity, income and expenses.

5.1. Accounting Policies and Options for Recognition, Measurement and Presentation of Assets in the Financial Statements

Assets represent economic resources that the entity controls in order to obtain future benefits. These resources can be classified according to the object of activity of the entity as follows:

1) economic goods used in the long term (fixed assets: land, buildings, machinery, equipment, licenses, etc.);
2) economic goods held in the short term for the purpose of sale (stocks of finished products, goods);
3) securities (financial assets: shares, bonds, other securities);
4) receivables (amounts of money to be collected from customers);
5) liquid assets or cash equivalents.

The recognition of assets is the process of including them in the financial statements in accordance with the criteria defined by the legislative framework in force. Also, to be recognized in accounting, the elements of the financial statements must be evaluated in order to determine the value at the time of entry (initial evaluation) or exit (subsequent evaluation) into and from the entity or at the end of each financial year during the inventory.

The existence of several ways of evaluating asset elements causes the appearance of accounting options. In this context, the management of the entity must present in the explanatory notes to the financial statements the valuation bases applied as part of the accounting policies adopted so that the users of the financial-accounting information are not misled.

Through accounting policies, economic entities must develop criteria consistent with the definitions of different asset categories, focusing on obtaining future economic benefits. Thus, in order to determine the economic benefits, an analysis of the main reasons for acquiring or producing an asset is necessary.

The establishment of accounting policies is carried out by appeal to professional reasoning, and the principle of the permanence of the methods requires their application consistently over a period of time as long as possible.

The accounting policies and options regarding the recognition, evaluation and presentation of asset elements in the financial statements of the economic entity are presented, in a general way, in ***Figure 3:***

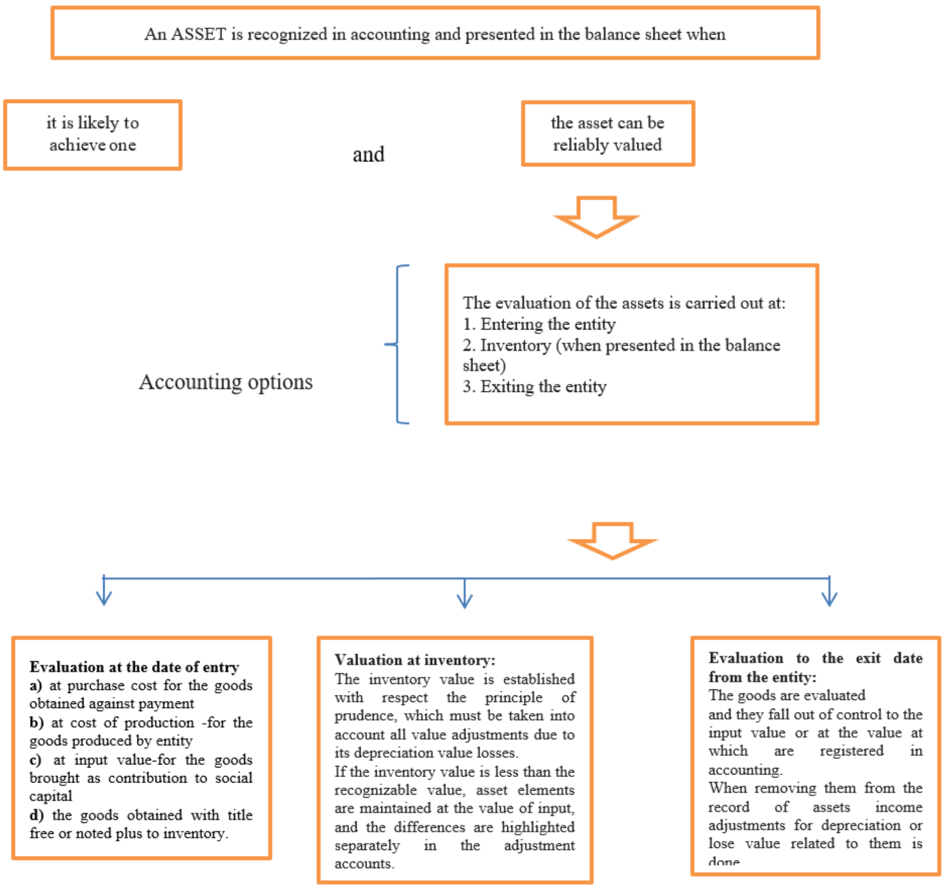

Figure 3. Recognition, Evaluation and Presentation of Assets in the Financial Situations

Source: personal projection

5.2. Accounting policies and options for the recognition, evaluation and presentation of liabilities in the financial statements

Liabilities/debts are present obligations of the economic entity arising from contracts and commitments concluded with third parties (example: debts towards suppliers), from legal provisions (example: tax debts) or from the adopted accounting policies (example: implicit debts[1]). These obligations are based on past events, and their settlement involves an outflow of resources incorporating economic benefits.

The recognition in accounting and the presentation of a liability in the balance sheet implies compliance with the following criteria:

- the existence of a current obligation of the entity;
- debt settlement determines an outflow of resources that includes economic benefits;
- the liability can be credibly valued.

As for the value of the liabilities elements, it generally results from the contracts assumed with third parties, from the operations carried out or from the supporting documents. When the value of a liability cannot be determined precisely, professional accountants resort to estimates, this uncertain liability being called a provision.

Provisions are recognized in accounting only if the conditions required by standards or regulations are cumulatively met. ***Figure 4*** shows the criteria for recognizing provisions provided in OMFP 1802/2014, with the mention that these conditions are taken from IAS 37 *Provisions, contingent liabilities and contingent assets.*

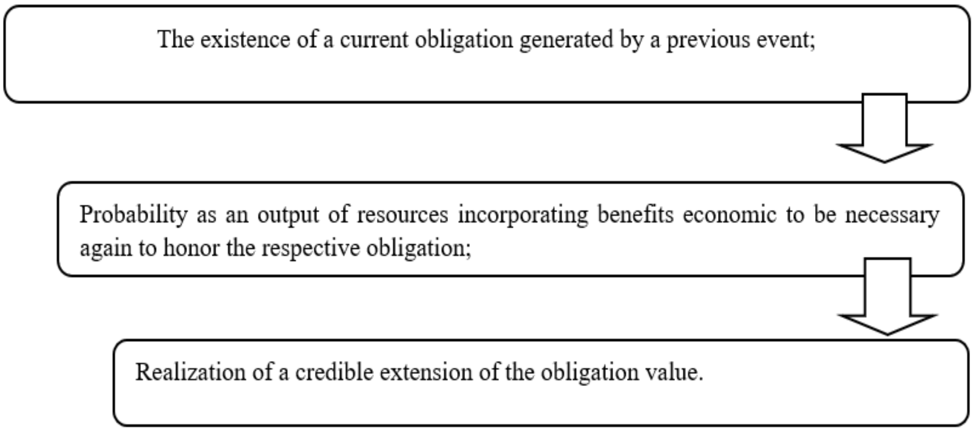

Figure 4. Conditions to be Met to Recognize a Provision

Source: personal projection

[1] An implied liability exists when the entity has assumed certain responsibilities through its accounting policies without a legal obligation to do so.

Once recognized, these uncertain obligations of the entity must be analyzed, evaluated and reviewed annually, at the time of the balance sheet, to reflect the best estimate of the costs required to settle the current debt.

The provisions policy provides the entity's management with tools to manipulate the information provided by the financial statements. The way provisions are set up has an impact on the entity's financial performance, as the increase in expenses causes a decrease in the recorded result and, implicitly, a decrease in the profit tax. For these reasons, the evaluation of provisions is done before taxation, and their fiscal treatment is provided by the legislation in force.

5.3. Accounting Policies and Options Regarding the Evaluation and Calculation of the Result as a Dimension of the Entity's Performance and Object of Taxation

The performance of the entity is reflected in the Profit and Loss Account through ***the result*** determined as the difference between the revenues and expenses recorded throughout a financial year. The recognition of incomes and expenses in accounting is closely related to their evaluation and is carried out according to its own rules. Depending on the accounting treatments applied to the structures of incomes and expenses that are used by the management of the entity, the quality of the result can be appreciated as a dimension of the entity's performance.

Starting from the certainty that different methods lead to different results, we identify two aspects to be analyzed in the choice of accounting policies and methods that influence the quality of the profits obtained by the economic entity. The first aspect refers to the fact that some accounting treatments are more conservative than others, the prudence shown by the management of the entity leading to the presentation of a diminished result. The second aspect concerns precisely the freedom of action allowed by the rules in the choice of accounting methods. In this context, the specialized literature draws attention to the subjectivity with which accounting treatments favorable to the entity are chosen and presents lower current profits as higher quality profits, obtained as a result of observing the principle of prudence.

The evaluation and calculation of the result as a dimension of the entity's performance must be done from two perspectives: the accounting and the fiscal one. Thus, two different types of results are determined: the accounting result and the tax result, whose calculation formulas are presented in ***Figure 5***:

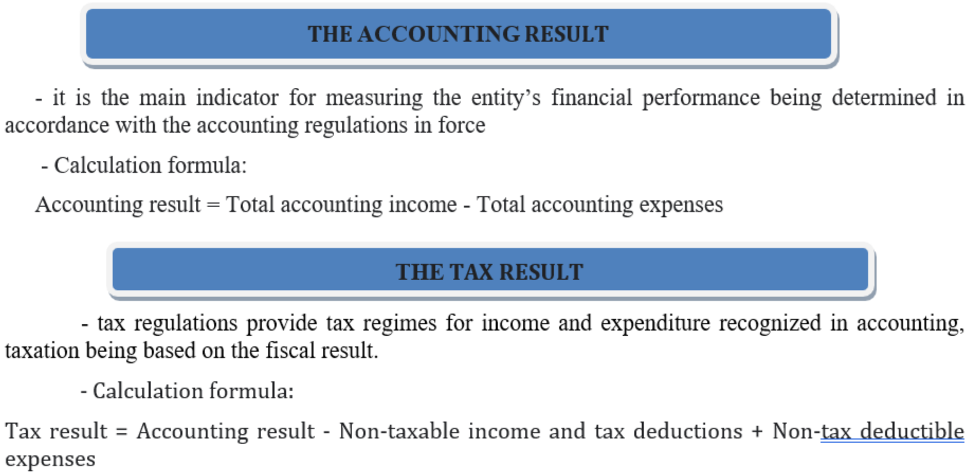

Figure 5. The Accounting Result Versus the Tax Result
Source: personal projection

Approaching the result as an object of taxation requires a fiscal analysis of the income and expenses recognized and evaluated in accounting. In this sense, we will study the tax regulations in our country in order to identify the recognized income and expense structures in order to determine the profit tax ***(Figure 6).***

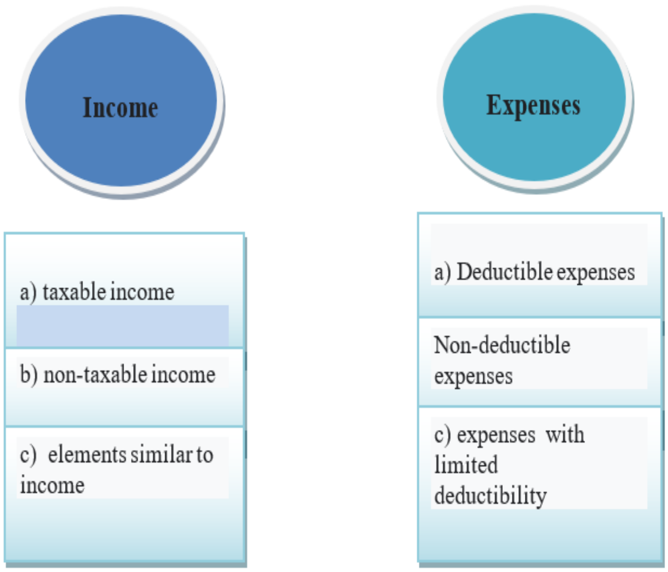

Figure 6. Recognition of Revenues and Expenses from a Fiscal Point of View
Source: Law no. 227/2015 accoding to the Tax Code

Inconsistencies between tax laws and accounting rules lead to differences between the accounting and fiscal results (Walton, 1996, p. 36), differences classified into two categories:

1. permanent differences;
2. temporary differences.

The category of permanent differences includes non-taxable income, tax reductions and exemptions, as well as non-deductible expenses. Temporary differences can be taxable or deductible and arise as a result of differences recorded between the tax base of an asset or liability and their carrying amount presented in the statement of the financial position.

Accounting policies related to the taxation of profit differ depending on the situation of the entity that records and accounts for current tax expense and deferred tax expense. Deferred tax accounting has become a challenge for the Anglo-Saxon accounting environment since the 60s (Langot, 1992, pp. 247-248), so that later this issue to be addressed at the level of international accounting standards through IAS 12 “Income Tax”. Although the Romanian normalizers had as a source of inspiration the international norm, the domestic accounting regulations do not refer to deferred taxes. However, economic entities in our country that prepare financial statements in accordance with IFRS can use the deferred tax method.

The need to reflect the deferred tax occurs as a result of accounting treatments different from fiscal ones, this tax being affected by temporary differences, as shown in ***Figure 7***:

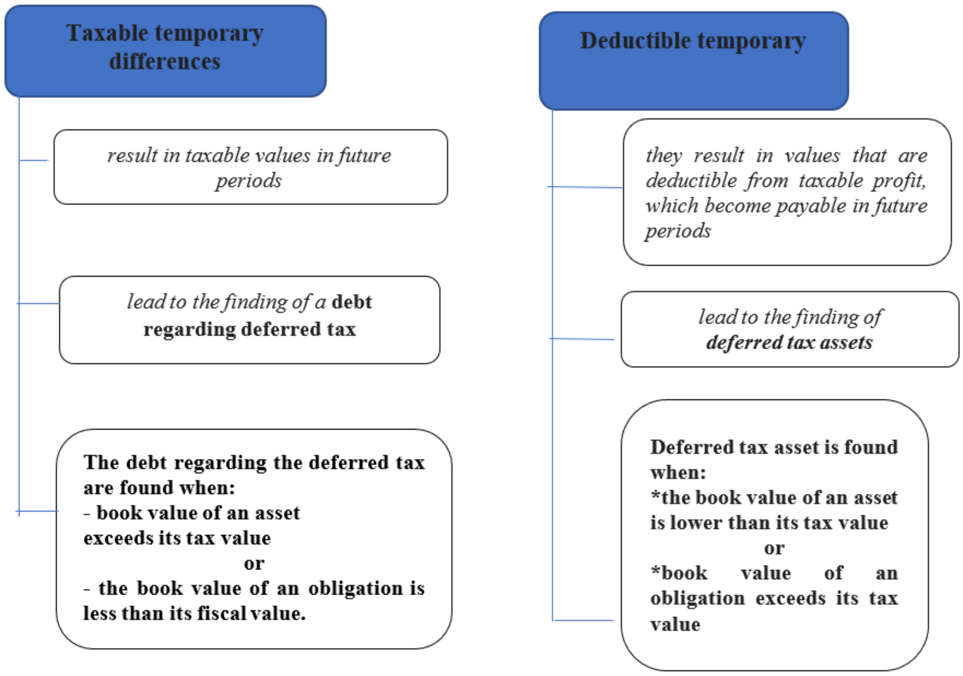

Figure 7. Deferred Tax between Taxable and Deductible Temporary Differences
Source: personal projection

Temporary differences arise as a result of transactions that affect the annual financial statements. For example, the following events have an impact on the profit and loss account and lead to the emergence of taxable or deductible temporary differences - income from the sale of economic goods, respectively the costs of stocks sold before the balance sheet date are included in the accounting result when the goods are delivered and in the result taxable at the time of collection. Also, deferred taxes based on temporary differences can cause changes in the entity's financial position by generating long-term liabilities or receivables.

The approach to the result as a dimension of the entity's performance and as an object of taxation is reflected in the financial statements. As a result, the accounting policies developed regarding the recognition, estimation and evaluation of income and expenses must be explained in the annex to the financial statements in order to provide quality information to the parties interested in the activity of the economic entity.

5.4. Accounting Policies and Choices Regarding the Capitalization Method and the Result Method

Economic entities can choose, within the framework of accounting policies, between ***the capitalization method*** and ***the result method*** for the accounting of some component elements of the financial statements. For example, management must decide whether incurred costs should be recognized in the income statement or whether they should be capitalized.

A particular case, which we will focus on further, refers to the accounting of borrowing costs, the accounting treatment of which can be found in IAS 23 *Borrowing costs.* According to the international standard, borrowing costs are defined as the total interest and other expenses incurred by the economic entity forced to contract loans in order to finance the acquisition or production of long-term assets. The elements listed in ***figure no.8*** are included in the borrowing costs:

THE BORROWING COSTS include:	a) the total interest expense calculated by the interest method effective as described in IAS 39 Financial instruments: recognition and evaluation;
	b) financing expenses related to financial leasing contracts recognized in accordance with IAS 17 Leases;
	c) exchange rate differences related to loans in a foreign currency, to the extent that they are viewed as an adjustment of expenses with interest.

Figure 8. The Borrowing Costs – Composing Elements

Source: IAS 23 Borrowing costs

IAS 23 provides as the basic accounting treatment of debt costs their registration in the expenses of the current financial year, being recognized as costs of the period. However, the same standard allows, under alternative accounting treatment, the consideration of borrowing costs as elements of the cost of acquisition or production of a long-term asset.

Accounting for debt costs can be done using the capitalization method or the result method, and the existence of the two options allows modeling the entity's financial position and performance through the lens of fiscal implications and the issue of capital maintenance ***(Figure 9).***

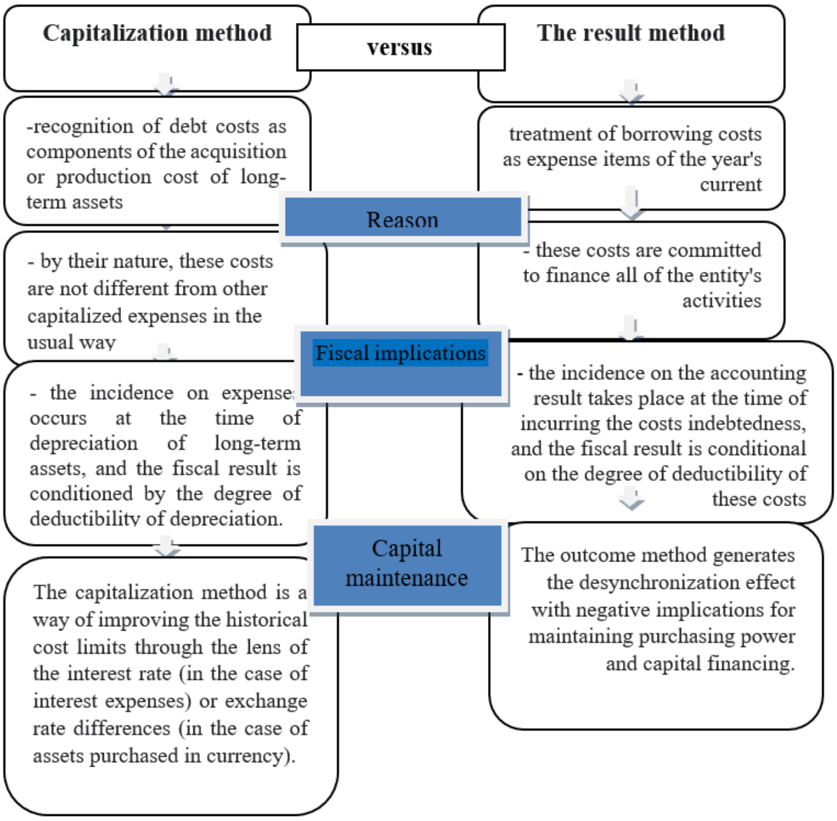

Figure 9. The Capitalization Method Versus the Result Method in Accounting for Borrowing Costs.

Source: adaptation acc. to Ristea M., Dumitru C.G., (2012), Libertate şi conformitate în standardele şi reglementările contabile, CECCAR Publishing House, Bucureşti, pp. 127-128.

Accounting for the borrowing costs becomes problematic when they are selectively capitalized for certain assets with a long production cycle. In this case, in order to avoid the manipulation of financial-accounting information and to ensure their comparability and relevance, economic entities are obliged to consistently apply the alternative treatment chosen, allowed by the legislation, presenting it in the explanatory notes to the financial statements.

The option for the capitalization method or for the result method is also valid in the case of research and development expenses, government subsidies, establishment expenses, transport-supply expenses, subsequent costs regarding tangible assets, etc. However, regardless of the elements subject to capitalization or recognition in the income statements, we can conclude that the establishment of accounting methods must be carried out in accordance with the entity's strategy and analyzed according to the impact they have on the information provided by the financial statements.

5.5. Accounting Policies and Options Related to Ensuring the Comparability and Relevance of Financial-Accounting Information Provided to Users

Economic entities tend to modify and adjust the accounting policies developed or revise the initial estimates to adapt to the constantly changing business environment. Thus, some policies considered favorable at a given moment for achieving the objectives set by the entity/s management may become unfavorable due to the new conditions that characterize the economic reality.

Changing accounting policies is permitted by legislation in certain cases, but we draw attention to the fact that repeated changes lead to a decrease in the confidence of users of financial-accounting information in the content of the summary documents presented by the entity. ***Figure 10*** shows the cases in which the accounting policies of the entity can be adjusted and modified in accordance with the legal regulations in force.

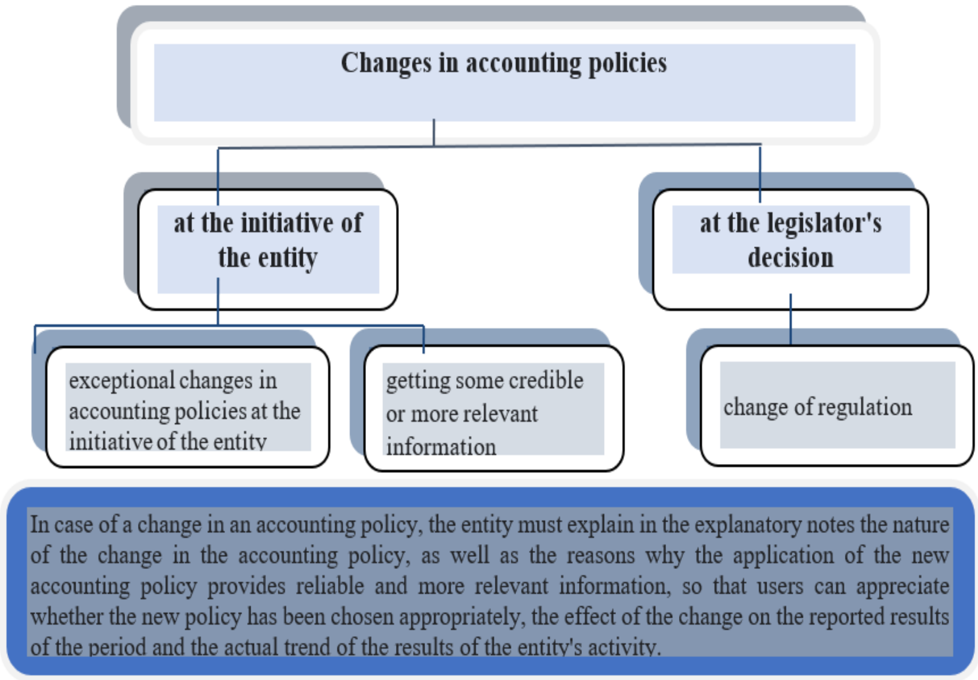

Figure 10. Changes in Accounting Policies
Source: OMFP nr. 1802/2014, art. 62 și art. 64

In the case of changes in accounting policies at the initiative of the entity, the law imposes the obligation to justify it in the annexes of the financial statements; instead if the accounting policies are changed as a result of a decision of the competent authorities, the changes thus appearing must not be justified, but only presented in the explanatory notes.

The Romanian accounting legislation allows certain situations in which the economic entity is able to modify its previously adopted and applied accounting policies, examples of such situations being presented in ***Figure 11.***

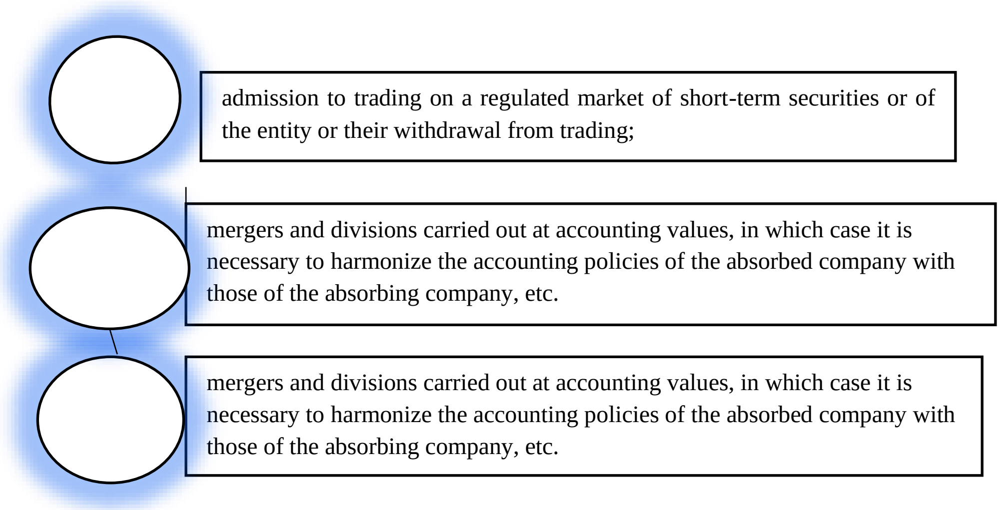

Figure 11. Examples of Situations that Justify the Change of the Accounting Policies:
Source: OMFP no. 1802/2014, art. 62.

Next, it is important to identify the appropriate moment to recognize the change in accounting policies, as follows:

➢ if these changes can be accurately determined, account 1173 “Reported result from changes in accounting policies” will be used in order to highlight the effects of changes in accounting policies on previous financial years;

➢ if these changes cannot be determined accurately, the result of the new policies will be recorded starting with the current financial year and continuing with the following ones. It should be noted that, in this case, the effects of the change in accounting policies are accounted for using income and expense accounts.

Standardizers insist that once accounting policies have been established, they should be maintained for as long as possible. The obligation to justify the accounting policies in the explanatory notes of the financial statements is imposed to ensure the comparability and relevance of the financial-accounting information provided to users. Otherwise we ask ourselves “What if these policies change frequently? Can an entity that unjustifiably changes its accounting policies still claim to provide a true picture of its activity?”

We have already noticed that national accounting regulations allow changes in accounting policies, but situations where this is possible should be seen as an exception to the rule. At the international level, analyzing the provisions of IAS 8 A*ccounting policies, changes in accounting estimates and errors*, three cases are identified in which changes in accounting policies are allowed, namely (Ristea & Dumitru, 2012, p. 39):

- if required by regulations;
- if imposed by an accounting rule;
- if they result in more relevant or reliable information about the financial position and performance of the enterprise.

Any other situations where accounting policies are unduly changed represent opportunities to manipulate financial statements.

In a broader sense, the category of changes in accounting policies also includes the changes made in accounting estimates, respectively the correction of errors. Estimates in accounting are evaluations or judgments made based on professional judgment according to the circumstances existing at the time of preparing the financial statements. Thus, there are accounting elements – provisions, economic life and residual value of fixed assets, fair value of financial assets, etc. - which cannot be accurately assessed at a given time due to uncertain or incomplete information, and it is necessary to use estimates regarding their size. In accordance with the above-mentioned information, IAS 8 *Accounting policies, changes in accounting estimates and errors* establishes that accounting estimates are the result of uncertainties inherent in commercial activities, they can be revised as a result of changes in the circumstances that led to the previous estimate. Any revision of the accounting estimate has effects on the result of the current year and/or on the results of future financial years, therefore it is mandatory to present the nature and value of the change in the accounting estimate in the annexes of the financial statements.

Accounting errors can result from the recognition, evaluation, presentation or description of the component elements of the annual financial statements. These errors are significant if they influence the economic decisions of users of financial-accounting information, and, as a result it is necessary to correct these mistakes. Accounting errors related to the current period are corrected on account of the profit and loss account, and accounting errors related to previous financial years are corrected and recognized on account of the retained earnings. In both situations, the correction of accounting errors affects the financial position and performance for the current year, and the resulting changes must be presented in the explanatory notes.

6. Cosmeticizing Financial Statements through Biased Accounting Policies and Choices

The possibility of choosing favorable accounting policies allows the management of the entity to adjust, within a legal framework, the presentation and content of the financial statements. Thus, they resort to ***accounting ploys*** that exploit existing loopholes in the rules, these practices - known as creative accounting - substantially affecting the users' perception of accounting information provided by financial statements. Accounting choices often have negative consequences on the economic decisions that are based on the information provided by accounting.

6.1. Cosmeticizing the Financial Statements as a Result of the Choice of Accounting Policies

The presence of options in accounting gives the entity's management the freedom to shape the result and content of financial statements according to the interests pursued. Whether we are talking about accounting choices or discretion in the context of accounting records, we must take into account the subjectivity involved in the judgment of accounting professionals, because it is obvious that the presence of options provides a fertile ground for the emergence of creativity in accounting.

The objectives of the accounting policies ***(Figure 12)*** are specific to each company, but they have in common the following aspects: reporting reduced losses or low taxable profits, increasing performance to attract new investors, reporting constant or stable financial results whose role is to reduce financial risk noticeable by the business environment.

Figure 12. The Objectives of the Accounting Policies

Source: Adapted from (Joffre & Simon 1989, pp. 2088-2089)

The field of application of the accounting policies consists of all the choices made regarding the accounting variables that have a positive or negative impact on the content and/or form of the financial statements prepared and published by the company (Cernușa, 2004, p. 402).

The accounting policies developed and adopted by the entity have consequences on the size of the result, and management decisions determine the strategy of the entity regarding profit maximization or minimization. The impact of the chosen strategy differs according to the accounting system adopted by each country and, in simple terms, refers to the attention given to taxation or the attention given to investors as privileged users of accounting information. In this sense, creative accounting techniques and methods are used, which can also be classified according to the change in the result and financial position of the economic entity ***(Table 1).***

Table 1. Another Classification of Creative Accounting Techniques

Creative accounting techniques that target	**Consequences**
1. The income statement and accounting policies	Change in current result and net result (depreciation, provisions, inventories, expense reporting)
	Change in current result without influencing the net result
	Change in net result without influencing the current result (subsidies for investments, imputation methods a fiscal deficit)
	Taxation and accounting policies (activation expenses)
2. The income statement and management decisions	Improving the current result (improving production, mitigating or loss transfer)
	Improvement of the net result (lease-back)
3. The balance sheet	Equity improvement (asset revaluation, financial montages)
	Improvement of permanent loans (leasing, debt relir in fact)
	Improving the need for working capital and a treasury (discounting trade effects)

Source: Bonnet F., (1995), Pièges (et dèlices) de la comptabilité (creative), Economica, Paris.

The mode of action of the various accounting policies adopted by the enterprise, but also the impact of their choice on the modeling of the financial position and performance are further presented to better understand how the techniques and practices of creative accounting work.

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6.2. Optimistic and Pessimistic Approaches in the Development of Accounting Policies for Modeling the Position and Performance of Economic Entities

The accounting policies developed and adopted by the economic entity give its management the opportunity to choose among the alternative treatments permitted by the rules, those that give an improved picture of the financial position and performance. The modeling of economic reality is the result of accounting choices that underlie the use of creative accounting techniques.

The choice of accounting policies allows management to achieve its set objectives regarding the value dimension of the result or regarding the content of the financial statements. The freedom of action offered by the presence of options in accounting influences the quality of financial-accounting information and affects the economic decisions made on their basis.

The field of application of the accounting policies consists of all the choices made on the variables that have a direct effect on the preparation and presentation of the financial statements. The manipulation of these variables has consequences on determining the position and financial performance of the entity, an example of this being illustrated in ***Figure 13:***

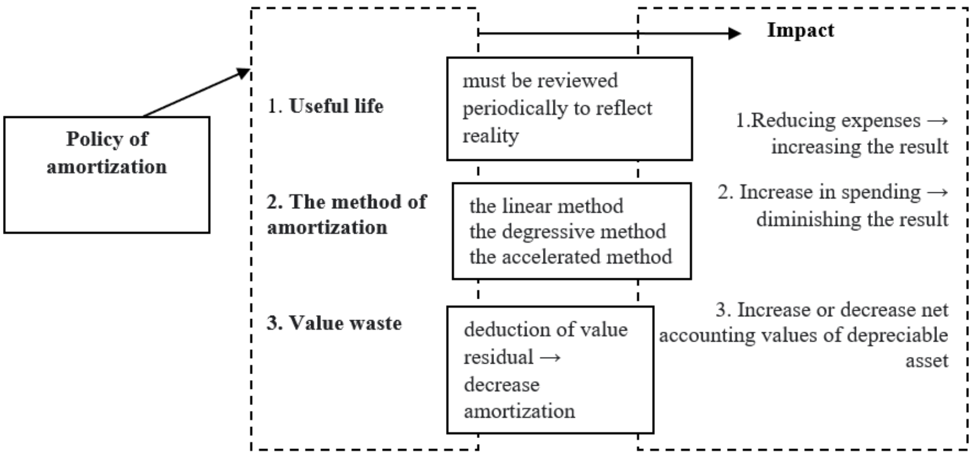

Figure 13. Amortization Policy – Impact on the Entity's Financial Position and Performance

Source: personal projection

Optimistic or pessimistic approaches of management in the development of accounting policies determine the strategy of the economic entity regarding the size of the result. Thus, a profit maximization strategy aims at attracting investors, and a profit minimization strategy involves avoiding the fiscal pressure by reducing the profit tax. Regardless of the strategy chosen, the subjectivity of the management that pursues its interests intervenes in determining the result, in this sense the game of options offering a fertile ground for the manipulation of the annual accounts. For example, subjectivism appears when management can show accounting optimism or pessimism in the case of accounting for merchandise stocks ***(Figure 14).***

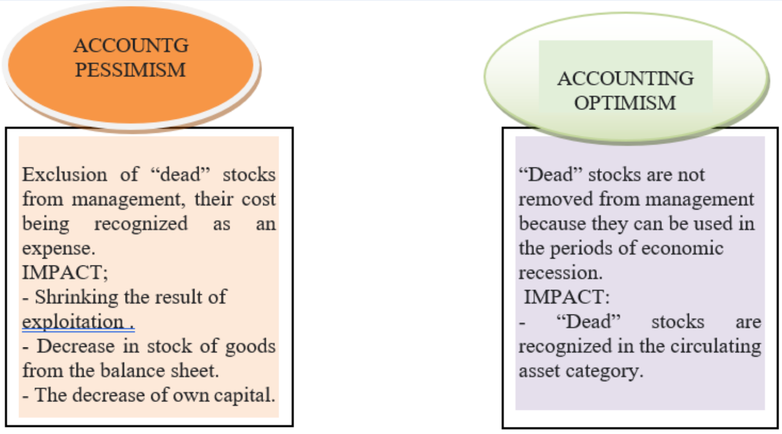

Figure 14. Opportunities for Subjectivism in Inventory Accounting
Source: personal projection

Modeling the financial position and performance of the economic entity is the consequence of the accounting policies and options developed and adopted by the management. The margin of freedom offered by the accounting rules is embodied in the choice of accounting methods favorable to the presentation of a desired image of the annual accounts. The pessimistic or optimistic attitude of management in the development of accounting policies implies subjectivity, and subjectivity represents an opportunity to manipulate the information presented in the financial statements.

7. Comparative Study on the Image Reflected by the Adoption of Accounting Policies with Different Objectives

The accounting policies developed and adopted by the entity determine the quantity and quality of information provided by the financial statements, the role of accounting being to generate the best information for optimal decisions. As stated in the previous paragraphs, obtaining the true picture of the financial position and performance of the enterprise remains a desideratum for accounting science because there is certain flexibility in the accounting rules allowed by the existence of alternative options and treatments. Thus, the possibility of choosing between different accounting policies leads to obtaining different results, a fact that affects the image of the information provided by the company.

Next, we carry out a ***comparative study*** in accordance with the national accounting and tax regulations in force, through which ***we demonstrate the implications of the accounting policies chosen by the enterprise on the quality of the accounting information provided by the financial statements***. It is worth mentioning that the present study is based on three sets of accounting policies with different objectives, namely:

- the first set of accounting policies aims to maximize profit;
- the second set of accounting policies aims to maintain capital, business continuity and business development;
- the third set of accounting policies aims to comply with the tax legislation in force.

The accounting policies that fall into the first set denote an aggressive behavior of the company in order to obtain as much profit as possible, and the rules adopted in this case aim to reduce expenses, without changing the level of income (***Table 2***).

Table 2. Examples of Accounting Policies Aimed at Maximizing Profit

• Inclusion of establishment expenses in the category of intangible assets
• Recognition of research and development expenses in the research phase
• Decreasing depreciation expense as a result of establishing long life spans economic
• The choice of the linear depreciation method
• The elements in the category of fixed assets that have an input value lower than the limit established by the legislator (2500 lei) are recognized as fixed assets and are amortized over a longer period of time
• The subsequent expenses related to fixed assets located on the border between the modification and maintenance of performance are recognized as fixed assets
• Capitalization of interest due to finance the purchase or construction of assets with a long manufacturing cycle
• Choosing the FIFO (first-in-first-out) method for exit valuation a stock
• Recording of reduced impairment adjustments under the valuation conditions at inventory

Source: personal projection

The accounting policies that fall into the second set denote a conservative behavior of the company in order to maintain the capital, and the rules adopted in this case aim to respect the principle of activity continuity ***(Table 3).***

Table 3. Examples of Accounting Policies Aimed at Maintaining Capital

• Inclusion of establishment expenses in the period expenses category
• Recognition of research expenses when they are incurred
• Correlation of the economic lives of fixed assets with their mode of use effects
• Choosing the LIFO method (last in - first out) or the CMP method (cost weighted average) for stock exit valuation
• Recording interest due to finance the acquisition or construction of assets with long manufacturing cycle in the category of expenses of the period
• Establishing clear technical criteria for the allocation of subsequent expenses carried out with tangible assets in the category of expenses of the period or in category of tangible assets
• Periodic revaluation of tangible assets
• Recording of impairment adjustments

Source: personal projection

The accounting policies that fall into the third set are not based on a specific strategy, but they are established by complying with the tax rules that take precedence and are confused with the accounting rules. In this case, the entity can aim to minimize the profit tax by deferring it in time, and this is possible by using different tax methods ***(Table 4).***

Table 4. Examples of Accounting Policies Aimed at Complying with Tax Laws

▪ Recognizing the input value of items as deductible expenses.
▪ Choosing the method of amortization (linear, degressive and accelerated) – the method that favors the postponement of the tax burden is chosen.
▪ Choosing the method of out-of-stock evaluation – the CMP or LIFO method can be chosen because they allow the valuation at the highest cost.

Source: personal projection

The case study is built on the basis of information extracted from the financial statements of the year 2021 (the balance sheet and the profit and loss account) and considers certain economic-financial transactions that can differentiate between the three sets of accounting policies analyzed.

The data on the basis of which the practical application is made are the following:

1.	In December 2020, the company purchased office furniture.	69.000 lei
2.	In March 2021, the company amended the constitutive act, the expenses generated by this operation amount to 13,800 lei.	13.800 lei
3.	Durng April - May 2021, the company made research and development expenses whose recognition as assets is not clear.	52.095 lei
4.	In December 2021, the company purchases a microwave oven.	1.955 lei
5.	The company owns a building whose accounting value is 632,500 lei.	632.500 lei

6.	The building is depreciated using the straight-line method, the remaining depreciation period is 15 years, and the remaining depreciable value is 368,000 lei.	368.000 lei
7.	In December 2021, the building is renovated.	42.550 lei
8.	The company owns some equipment with an accounting value of 80,500 lei.	80.500 lei
9.	The life of the equipment is 5 years and it is depreciated for the amount of 64,400 lei.	64.400 lei
10.	The company owns assets with a long manufacturing cycle (tangible assets in progress).	101.200 lei
11.	The interest related to loans taken to obtain assets with a long manufacturing cycle is 11,500 lei.	11.500 lei
12.	Initial balance of goods stocks (01.01.2021)	144.900 lei
13.	Final balance other stocks (31.12.2021)	161.000 lei
14.	Other assets	276.000 lei
15.	Total liabilities (31.12.2021)	681.950 lei
16.	Total revenues (31.12.2021)	2.127.500 lei
17.	Expenses[1] (31.12.2021)	1.524.900 lei
18.	Inventory exit valuation: - the CMP method - the FIFO method - the LIFO method	 127.795 lei 127.650 lei 128.800 lei

1. *Treatments specific to the first set of accounting policies – calculations and impact on financial statements:*

✍ The costs of amending the constitutive act are considered costs of incorporation and are included in the category of intangible assets, being assets. These expenses are amortized over 5 years, using the straight-line method, so in 2021, the amortization will be:

13.800 lei /5 years * 9/12 = 2.070 lei

✍ Depreciation of the office furniture is carried out using the straight-line method, and the normal duration of use is 10 years, thus the depreciation recorded in 2021 is in the amount of:

69.000 lei /10 years = 6.900 lei

✍ The evaluation of stocks at the exit is carried out by the FIFO method (127,650 lei). ***Table 4*** summarizes the impact of the first set of accounting policies, as follows:

[1] The expenses are fully deductible and do not include the expenses for the depreciation of the office furniture, nor the other expenses resulting from the detailed economic-financial operations.

Table 5. The Impact of the First Set of Accounting Policies on the Financial Statements

Elements	Value	Explanations
Impact on the balance sheet		
Establishment expenses	11.730 lei	The establishment expenses of the company are recognized as assets at the cost of entry less accumulated depreciation.
Research and development expenses	52.095 lei	Research and development expenses are recognized in the category of intangible assets.
Buildings	307.050 lei	Building renovation costs are included in its value.
Office furniture	62.100 lei	Deduct the depreciation related to 2021 from the value of the furniture.
Equipment	16.100 lei	The new book value of the equipment is calculated as the difference between the entry value and the remaining depreciable value.
Microwave oven	1.955 lei	he microwave oven is recognized in the category of fixed assets, although the limit established by law (2500 lei) is not exceeded.
Corporal immobilizations taking course	112.700 lei	The value of fixed assets in progress includes the interest on their related loans.
Stock goods	17.400 lei	The stock of goods is evaluated using the FIFO method (144,900 lei-127,650 lei).
Other stocks	161.000 lei	Not influenced by the adopted policy.
Other assets	276.000 lei	
TOTAL ASSETS	1.018.130 lei	All the assets described above are added.
TOTAL LIABILITIES	681.950 lei	Not influenced by the adopted policy.
OWN CAPITAL	336.180 lei	Active – Datori
Impact on profit and loss account		
Depreciation expenses	8.970 lei	They are related to establishment expenses and office furniture.
Goods expenses	127.650 lei	The FIFO method is used.
Total expenses resulting from the application of accounting policies	136.620 lei	8.970 lei + 127.650 lei
Expenses	1.524.900 lei	Not influenced by the adopted policy.
Total expenses	1.661.520 lei	136.620 lei + 1.524.900 lei
Revenues	2.127.500 lei	Not influenced by the adopted policy.
Result	*465.980 lei*	2.127.500 lei – 1.661.520 lei

Source: the authors' design and processing

2. Treatments specific to the second set of accounting policies – calculations and impact on financial statements:

- Depreciation of office furniture is carried out using the accelerated method, and the useful life duration is 5 years, thus the depreciation recorded in 2021 is:

69.000 lei * 50% = 34.500 lei

- The stock evaluation at the exit is carried out by the LIFO method (128.800 lei).
- The building will be reassessed at the value of 287.500 lei.
- A depreciation of the equipment is recorded, its market value being 11.500 lei.
- A depreciation of other stocks is recorded, their new value being 132.250 lei.

Table 5 summarizes the impact of the second set of accounting policies, as follows:

Table 5. The Impact of the Second Set of Accounting Policies on the Financial Statements

Elements	**Value**	**Explanations**
Impact on the balance sheet		
Buildings	287.500 lei	The fair value of the building as determined after revaluation.
Office furniture	34.500 lei	Deduct the depreciation related to 2021 from the value of the furniture.
Equipment	11.500 lei	The fair value of the equipment recorded after depreciation.
Corporal immobilizations taking course	101.200 lei	It is recorded at cost of production excluding interest.
Stock goods	16.100 lei	Merchandise inventory is valued using the LIFO method (144.900lei-128.800lei).
Other stocks	132.250 lei	Accounting value of other inventories recorded as a result of depreciation.
Other assets	276.000 lei	Not influenced by the adopted policy.
TOTAL ASSETS	859.050 lei	All the assets described above are added.
TOTAL LIABILITIES	681.950 lei	Not influenced by the adopted policy.
OWN CAPITAL	177.100 lei	Assets - Liabilities
Impact on profit and loss account		
Depreciation expenses	34.500 lei	They are related to office furniture.
Goods expenses	128.800 lei	The LIFO method is used.
Establishment expenses	13.800 lei	They are considered period costs.
Research and development expenses	52.095 lei	They are considered period costs.
Building renovation expenses	42.550 lei	They are considered period costs.
Expenses with adjustments for depreciation	33.350 lei	They are related to equipment and other stocks.
Interest expenses	11.500 lei	They are considered period costs.
Expenses with materials of the nature of inventory items	1.955 lei	The microwave oven is put into use and the related expense is recognized.

Total expenses resulting from the application of accounting policies	318.550 lei	The expenses described above are added.
Expenses	1.524.900 lei	Not influenced by the adopted policy.
Total expenses	1.842.450 lei	318.550 lei + 1.524.900 lei
Revenues	2.127.500 lei	Not influenced by the adopted policy.
Result	*284.050 lei*	2.127.500 lei – 1.842.450 lei

Source: the authors' design and processing

3. Treatments specific to the third set of accounting policies – calculations and impact on financial statements:

 The depreciation methods allowed by the tax law for office furniture are the straight-line method and the degressive method, and the company chooses the degressive method, the amortization period is 7 years, and the amortization calculated for the year 2021 is:

(69.000 lei / 7 years) * 2 = 19.714 lei

 The stock evaluation at the exit is carried out by the LIFO method (128,800 lei). ***Table 6*** shows the impact of the third set of accounting policies, as follows:

Table 6. The Impact of the Third Set of Accounting Policies on Financial Statements

Elements	**Value**	**Explanations**
Impact on the balance sheet		
Buildings	307.050 lei	Building renovation costs are included in its value.
Office furniture	49.286 lei	Deduct the depreciation related to 2021 from the value of the furniture.
Equipment	16.100 lei	The new accounting value of the equipment is calculated as the difference between the entry value and the remaining depreciable value.
Corporal immobilizations taking course	101.200 lei	It is recorded at cost of production excluding interest.
Stock goods	16.100 lei	Merchandise inventory is evaluated using the LIFO method (144.900lei-128.800lei).
Other stocks	161.000 lei	Not influenced by the adopted policy.
Other assets	276.000 lei	Not influenced by the adopted policy.
TOTAL ASSETS	926.736 lei	All the assets described above are added.
TOTAL LIABILITIES	681.950 lei	Not influenced by the adopted policy.
OWN CAPITAL	244.786 lei	Assets - Liabilities
Impact on profit and loss account		
Depreciation expenses	19.714 lei	They are related to office furniture.
Goods expenses	128.800 lei	The LIFO method is used.
Establishment expenses	13.800 lei	They are considered period costs.
Research and development	52.095 lei	They are considered period costs.

expenses		
Interest expenses	11.500 lei	They are considered period costs.
Expenses with materials of the nature of inventory items	1.955 lei	The microwave oven is put into use and the related expense is recognized.
Total expenses resulting from the application of accounting policies	227.864 lei	The expenses described above are added.
Expenses	1.524.900 lei	Not influenced by the adopted policy.
Total expenses	1.752.764 lei	227.864 lei + 1.524.900 lei
Revenues	2.127.500 lei	Not influenced by the adopted policy.
Result	*374.736 lei*	2.127.500 lei – 1.752.764 lei

Source: the authors' design and processing

It should be mentioned that the purpose of this comparative study is to show how financial reporting can be modified according to accounting policies adopted taking into account legal regulations. In order to achieve our aim, it is worth mentioning that we went a little overboard with the recognition of research and development expenses and the inclusion of the microwave oven in the category of tangible assets, even though the legal limit was not exceeded.

The figures obtained as a result of the study are presented in ***Table 7:***

Table 7. The Impact of the Accounting Policies Adopted by the Entity in 2021 – Comparative Analysis

Element		**Value (lei)**		
		The first set of accounting policies	**The second set of accounting policies**	**The third set of accounting policies**
THE ACCOUNTING BALANCE	Total assets	**1.018.130 lei**	**859.050 lei**	**926.736 lei**
	Total liabilities	681.950lei	681.950 lei	681.950 lei
	Own capital	**336.180 lei**	**177.100 lei**	**244.786 lei**
PROFIT AND LOSS ACCOUNT	Revenues	2.127.500 lei	2.127.500 lei	2.127.500 lei
	Expenses	1.524.900 lei	1.524.900 lei	1.524.900 lei
	Expenses resulting from policy enforcement accounting	**136.620 lei**	**318.550 lei**	**227.864 lei**
	Total expenses	**1.661.520 lei**	**1.843.450 lei**	**1.752.764 lei**
	Result	***465.980 lei***	***284.050 lei***	***374.736 lei***

Source: authors' processing

The representation of the impact of the accounting policies chosen by the economic entity on the balance sheet is made in ***Figure 1***; thus it can be seen that the assets and own capital have been modified as a result of the use of the alternative treatments provided by the legislation.

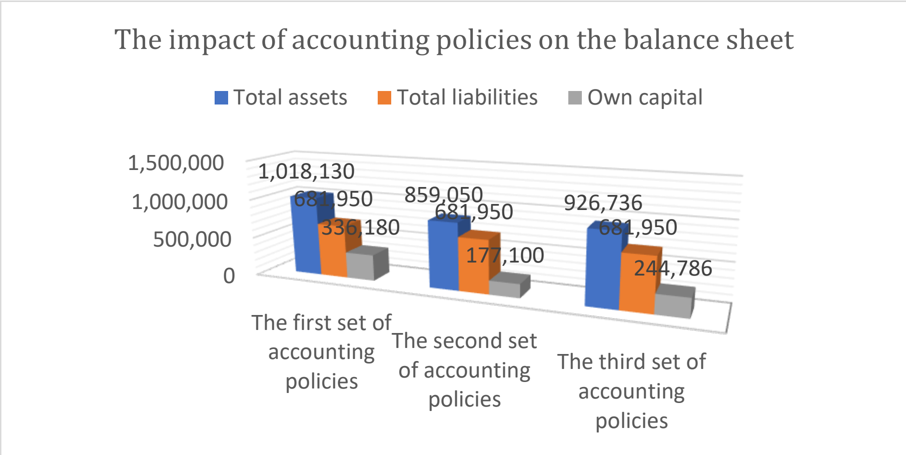

Figure 1. The Impact of Accounting Policies on the Balance Sheet
Source: personal projection

In ***Figure 2***, the implications of the accounting policies chosen by the entity on the profit and loss account are represented, thus highlighting that the basis for obtaining different results is the change in the value of expenses recorded by the entity.

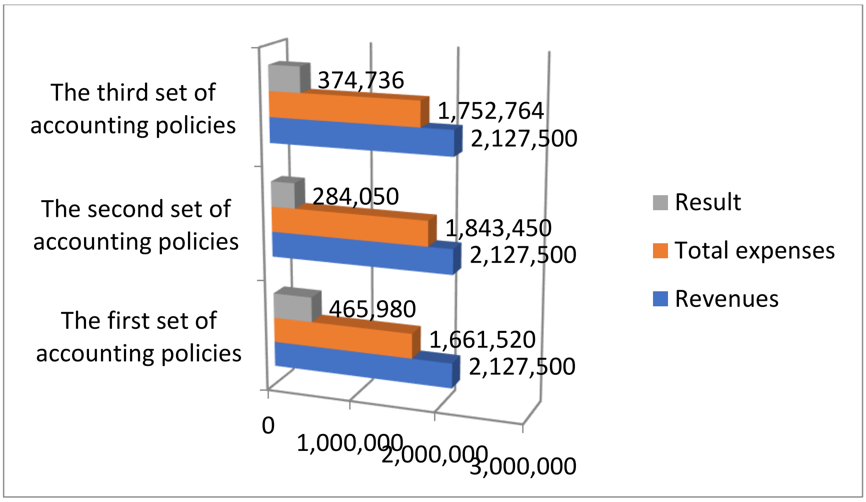

Figure 2. The Impact of Accounting Policies on the Profit and Loss Account
Source: personal projection

The conclusions of the conducted study refer, in the first phase, to the effect that different accounting policies have on the elements presented in the balance sheet and in the profit and loss account, as follows:

✓ The accounting policies change the company’s assets, the first set of accounting policies determines the highest value of assets (1,018,130 lei), and the application of the second set of policies leads to obtaining the lowest value of assets (859,050 lei);

✓ The accounting policies do not affect the company's debts, which usually happens in reality;

✓ Changes recorded in assets are also transferred to equities;

✓ Changing the accounting result obtained was the main factor that led to the choice of accounting policies;

✓ The increase or decrease of expenses were decisive in changing the result, because the income was not influenced by the chosen accounting policies;

✓ The lowest expenses were recorded in the situation of applying the first set of accounting policies, which is predictable when the objective of these policies was to maximize the result;

✓ The accounting results are obtained according to the applied strategy, thus important differences between the performances recorded following the application of the first, second and third set of accounting policies can be observed;

✓ The accounting result obtained in each of the three situations analyzed is the basis for the calculation of the profit tax, a fact illustrated in ***Table 8:***

Table 8. Calculation of the Profit Tax Related to the Results Obtained in the Analyzed Three Situations

Element	**Value (lei)**		
	The first set of accounting policies	**The second set of accounting policies**	**The third set of accounting policies**
Accounting result	**465.980 lei**	**284..050 lei**	**374.736 lei**
Establishment expenses	**-13.800 lei**	**X**	**X**
Accounting depreciation office furniture	**+6.900**	**+34.500 lei**	**+19.714 lei**
Tax depreciation	**-19.714 lei**	**-19.714 lei**	**-19.714 lei**
Equipment depreciation	**X**	**+4.600 lei**	**X**
Inventory depreciation	**X**	**+28.750**	**X**
Taxable result	**439.366 lei**	**332.186 lei**	**374.736 lei**
Profit tax	***79.299 lei***	***53.149 lei***	***59.958 lei***

Source: authors' processing

✓ In the case of the third set of applied accounting policies, it is observed that the accounting result is equal to the taxable one, which was expected to happen because in this case the entity chose accounting treatments identical to the fiscal ones.

✓ The application of different accounting policies has a “snowball” effect on the financial statements: the modification of one element changes other elements and so on, until we find ourselves in the situation of distorting the financial statements;

✓ The changes produced by each adopted policy have an impact on the current financial year (as seen following the analysis), but also on future financial years; for this reason it can be stated that, in fact, the registration of some elements or their value, partial or total, is postponed;

✓ The results obtained as a result of the application of policies with different objectives are modified according to the interests of the management, a fact that distances the entity from presenting a true picture of its financial position and performance. In this context, although the accounting policies comply with the regulations in force, a guarantee is required that the entity has not resorted to accounting manipulations in order to obtain undeserved advantages. Could the audit of the accounting statements be such a guarantee?

8. Conclusion

International and national accounting regulations offer economic entities the opportunity to choose a treatment, an accounting method or an evaluation rule from several alternatives to highlight the true picture of financial statements. The approval of certain accounting methods or treatments to the detriment of others is achieved through the accounting policies defined and applied by the entity as a result of compliance with generally accepted principles.

The impact of accounting policies on the activity of the entity is based on practical considerations because the need to establish the criteria for recognition, evaluation and presentation of the component elements of the financial statements arises to fulfill the informational role of accounting. The accounting policies chosen by the entity influence the quality and quantity of financial-accounting information provided to users for decision-making.

The existence of accounting policies and options creates a fertile ground for the manifestation of accounting creativity. Abusive use of alternative treatments can lead to modeling the financial position and performance of the entity, thus the image of the annual accounts is manipulated and the beneficiaries of the information provided by accounting are misled. To avoid this situation, they must know the accounting policies adopted by the entity. It is also recommended to maintain the accounting policies for as long as possible in order not to influence the financial statements.

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