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**Review Paper**

# CREATIVE CASH FLOW REPORTING

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**Abstract**. *Financial statements should realistically show financial position, performance, and cash flows of a company. Creative financial reporting represents a deliberate manipulation of information in financial statements in order to create misperceptions on company operations. Creative financial statements are primarily intended for investors, in order to encourage them to purchase company shares and thus increase its market value. Creativity in compiling cash flow statements lies in presentation of operating activities as investing and financing activities, and vice versa.*

**Key words**: *creative accounting, cash flow statement, operating activities, investing activities, financing activities*

**JEL Classification**: M41, M42

## INTRODUCTION

"As a social science, accounting is the product of its environment" (Saudagaran, 2009, 1). Changing economic circumstances in which reporting entities do business, primarily the global movement of capital, emergence of new forms of funding, and development of new technological and communication devices, created the need for further development of accounting standards. Economic globalization and the creation of global financial market significantly increased the possibility of creativity in financial reporting. Practice shows that creativity of accountants is now much higher than in the past. Particularly as a result of this creativity, credibility of financial statements and accountants themselves

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decreased. In order to make reliable and timely business decisions in today's business environment, the focus is on sound financial reporting.

The importance of cash flow statement arises from its connection with other financial statements, which allow management, as internal users, as well as external users, to gain complete insight into company's liquidity and solvency. Defining new amendments to standards referring to the area of cash flows has become a necessity, because it is necessary to provide additional assurance regarding the quality of cash flow reporting. The paper points to creative financial reporting, the importance of information on company cash flows, the impact of creative cash flow reporting on the presentation power of financial statements, and amendments to the current IAS 7.

## 1. CREATIVE FINANCIAL REPORTING

Financial statements are an indispensable source of information for making business decisions. However, for high-quality financial reporting, "a good normative basis is a necessary, but not sufficient condition" (Škarić-Jovanović, 2007, 52). Company management, "the only present stakeholder with control over the creation of financial statements" (Stevanović & Malinić, 2009, 63), is responsible for adequate implementation of the prescribed standards when preparing and disclosing financial statements. Recognizing the separation of company ownership and management, on the one hand, and development of financial markets, on the other hand, motivated some managers to use financial statements to obtain significant benefits for the company and for themselves.

"Creative financial reporting involves intentional, premeditated manipulation of information in financial statements in order to create misperceptions about the company's financial position and performance, and deceive certain stakeholders, particularly investors" (Malinić, 2009a, 140). Creative accounting practices in financial reporting are seen as "the art of faking the balance sheet" (Bertolus), "the art of calculating the balance sheet" (Lignon), "the art of presenting the balance sheet" (Gounin), and, finally, "the art of saving money" (Ledouble) (Tassadaq & Malik, 2015, 544).

"The complexity of business and financial life of the company, inability to develop perfect accounting rules for each specific situation, and existence of accounting options in order to elegantly solve reporting problems at the same time open up significant maneuver room for the creation of financial statements that may significantly deviate from economic reality" (Malinić, 2009b, 138). Each financial accounting activity, taken to create an image that is different from the real situation, can be classified as creative accounting. There are no clearly defined boundaries of permissible and impermissible activities and it is not defined which creative accounting act made by accountants exceeds flexibility of accounting regulations and turns into crime (Đukić & Pavlović, 2014, 226). Application of accounting rules in a way that is contrary to their spirit, or refusal to apply them represents the creative accounting decision that separates it from the financial reporting policy. Even though its targets are close to creative accounting ones, financial reporting realizes them only by using the space provided by standards offered (Škarić-Jovanović, 2007, 54). "Creative accounting is neither legal nor illegal, only the maximum use of it pushes a company in scandals" (Tassadaq & Malik, 2015, 550).

Creative accounting and its, unfortunately, widespread use in practice "does not have any positive connotation" (Malinić, 2009b, 138). The effects of creative accounting negatively affect investors and the company, accountants, as well as the national economy, which suffers damages based on capital market instability and the financial system as a whole. "A large number of stakeholders, such as investors, creditors, regulators, and labor, have learnt lessons from the crisis caused by the collapse of "Enron" and "WorldCom" companies in 2002" (Gherai & Balaciu, 2011). Creative financial reporting seriously threatens the use value of financial statements. It is self-evident that direct use of information contained in creatively prepared financial statements (for example, on profit, value of inventories, receivables, amount of liabilities, debt, etc.) is very risky, especially for external stakeholders (Malinić, 2009a, 156). One of the ways to overcome information asymmetry caused by creative financial reporting could be in broader and more reliable disclosures. "Disclosures regarding significant events that have affected business performance, ... are essential for the assessment of management's tendencies towards disclosure of specific accounting policies" (Denčić-Mihajlov & Spasić, 2016, 29). In the case of transition economies mandatory disclosures are often not able to prevent harmful creative accounting. For example, "low level of disclosure quality of Serbian companies could be attributed to ineffectiveness in the functions of internal and external auditors and poor corporate governance" (Spasić & Denčić-Mihajlov, 2014, 104). In that sense, users of financial statements should pay special attention to creative reporting issues.

"Using creative accounting always means giving priority to short-term objectives of management in relation to long-term goals of the company" (Škarić-Jovanović, 2007, 69). In today's dynamic business conditions, ethical behavior of accountants is a way to save the company from scandal and fraud. "It is clear that even the best designed programs and mechanisms cannot provide a guarantee that abuse will not occur, so internal audit is a function of which much is expected on this issue" (Đorđević & Đukić, 2015, 307). However, internal audit is not the only mechanism that can be used for this purpose. Internal control and external audit should also have significant roles in this process.

## 2. Importance of Cash Flow Statements in Financial Reporting

Cash flow statement is a financial report, whose task is to follow the money that goes in and out of the company. If information in this report connects adequately with information from other financial statements, it will provide management, as internal users, as well as external users, complete insight into company's liquidity and solvency.

Management uses this information when making series of business decisions and evaluating performance in the fields of achieving objectives, liquidity, dividend policy, then when reviewing results of operating, investing, and financing activities, and to determine contribution of each of these activities to business performance. Specifically, cash flow statement is an instrument that shows managers how changes in the balance sheet and income statement impact on cash. It also allows management, in the definition of the business policy, to recognize the main directions of its business activities and thus ensure maximum business success.

For external users, information in cash flow statement is critical for analyzing companies in terms of evaluating operating performance, liquidity, and solvency of the company.

Investors, creditors, government, and other interested users thus gain insight into the company profitability, its debt, and carry out risk assessment of cooperation with it.

"This statement, in most general terms, provides information to interested parties about where cash during the reporting period comes from, how cash is used during the reporting period, and what changes in cash occurred at the end compared to the beginning of the period" (Kimmel, Weygandt & Kieso, 2011, 15). "Cash flow statement explains what in the reporting period affected cash balance shown in the balance sheet at the beginning of the reporting period in order to come to a new cash balance at the end of the accounting period" (Libby, Libby & Daniel, 2011, 638).

## 3. Correlation between Cash Flow Statement and Other Financial Statements in Creative Financial Reporting

"Creative cash flow reporting is related to any step in order to create a different image than the actual cash flows, and in that way providing the wrong signal about the ability of the company to generate sustainable cash flows" (Mulford & Comiskey, 2005). There are accountants who are willing to take advantage of the flexibility offered by certain IAS in order to increase the amount of cash flows presented primarily from operating activities. Since operating activities include all activities from the main area of company's business, "sustainability of total cash flows depends directly on sustainability of cash flows from operating activities" (Đukić & Pavlović, 2014, 227). Therefore, despite the fact that creative activities increase net cash flow from operating activities, they, actually, "do not increase sustainable cash flows because it is a one-time increase" (Đukić & Pavlović, 2014, 230), which will not be repeated next year.

Creative alterations and amendments to cash flow statement are made to attract potential investors, for ease of obtaining favorable loans, and growth of share prices on the stock exchange. "They can comprise a wide range of legal and illegal management procedures" (Petrova, 2008, 24). There are two basic ways to creatively adjust operating activities in cash flow statement:

- Increase in cash inflow from operating activities, and
- Decrease in cash outflow from operating activities.

On the one hand, by expanding the definition of what makes inflows from operating activities and narrowing of what belongs to inflow from investing and financing activities, and, on the other hand, narrowing the definition of what makes outflows from operating activities and expanding what belongs to outflows from investing and financing activities, "the company wants to show itself as more successful" (Jones, 2011, 61) to their stakeholders.

Accounting theory and practice recognize the following methods to manipulate cash flow statement (Schilit & Perler, 2010, 190):

- Transferring cash inflow from financing activities to inflow from operating activities,
- Transferring cash outflow from operating activities to outflow from investing activities,
- Increase in cash flow from operating activities using acquisition of part or all of the company, and
- Increase in cash flow from operating activities using the additional "ancillary" activities.

Professional accountants know that, when expressing their creativity in preparing and presenting financial statements, they need to look at the interplay of financial statement items that make the annual statement. Specifically, change of a specific item of cash flow statement is caused by changes of certain items in income statement and/or balance sheet.

### 3.1. Correlation between income statement and cash flow statement in creative financial reporting

It must be borne in mind that any manipulation on income and expenses directly or indirectly affects cash inflows and outflows. Time mismatch between income and expense recognition transactions, on the one hand, and collection of receivables from customers and payment of liabilities to suppliers and creditors, on the other hand, can lead to a dilemma regarding classification of cash flows.

Generally, manipulation that links these two statements is reduced to increasing income and reducing expenses. In order to minimize doubts about the presented financial statements, managers carry out the so-called double manipulation, which includes artificial increase in sales revenue with an increased inflow from operating activities. However, "a large number of controllers who detect unrealistic increase in sales revenue neglect this fact, so that this kind of manipulation often does not get noticed" (Dimitrijević, 2015, 145).

IFRS provide opportunities for businesses to capitalize on certain business expenses or present them as an expense when incurred. One of the most common manipulations that connects income statement and cash flow statement is capitalization of costs from the group of operating costs. This operation can reduce expenses and improve business results. However, "a large number of companies forget that it burdens cash flows, which may result in a negatively expressed cash flow" (Dimitrijević, 2015, 147). When operating expenses are viewed as a cost, they reduce net result, and, consequently, net cash flow from operating activities. Their capitalization exempts them from expenses in income statement and they are presented as outflows from investing activities in cash flow statement. In this way, accountants achieve the objective of not reducing net cash flow from operating activities. It should be borne in mind that "effects of capitalization on cash flows from operating activities are especially evident when a company changes its capitalization policy" (Đukić & Pavlović, 2014, 232).

Period costs are capitalized to show better results, i.e. they are included in the value of assets belonging to fixed assets, so that they do not represent period costs. They are shown as costs at the time when those particular fixed assets are depreciated, so they are written off successively over several future periods. Most often capitalization applies when it comes to: marketing costs (according to IAS 38 - Intangible Assets), research and development costs (according to IAS 38 – Intangible assets), direct costs incurred prior to starting the plant (according to IAS 16 – Property, plant, and equipment), maintenance and repair costs (according to IAS 16 – Property, plant, and equipment), interest on loans used to purchase fixed assets (according to IAS 23 – Borrowing costs), and cost of software development (according to IAS 38 – Intangible assets) (Đukić & Pavlović, 2014, 231-232).

Costs incurred during the purchase of materials or goods by their nature cannot be part of cash flows from investing activities. Their goal determines classification of cash outflows as a component of operating activities (Stevanović, Belopavlović & Lazarević-Moravčević, 2013, 34). Treatment of certain current assets as a segment of fixed assets, i.e. of cash outflow for their purchase as outflow from investing activities, rather than presenting them as outflow from operating activities, leads to overestimation of net operating cash flow.

Companies of equal capital intensity can report on a different net cash flow from operating activities in the event that a company procures equipment on the basis of business lease, and a second company buys the same equipment. The company that leases equipment presents leasing costs as outflow from operating activities, while the company that buys equipment sees purchase costs as capital expenditure, and classifies them into cash outflow from investing activities (White, Sondhi & Fried, 2003). "Misrepresentation of outflows for leasing as investment and its exclusion from the group of operating cash flows would lead to overestimation of cash flows from operating activities" (Stevanović, Belopavlović & Lazarević-Moravčević, 2013, 35).

Another well-known example comes from the company "WorldCom", which committed one of the biggest frauds in financial statements in history. "WorldCom" presented its operating expenses as the purchase of fixed assets, and classified them in the cash flow statement as outflows from investing activities, rather than operating activities. In this way, "WorldCom" reclassified over 5 billion dollars in cash outflows during 2000 and 2001 from operating into investing activities (Beresford, Katzenbach & Rogers, 2003). Also known is the case of "Health South", which capitalized costs of sponsoring hockey team from Pennsylvania as costs of advertising in daily newspapers (Đukić & Pavlović, 2014, 231-232).

### 3.2. Correlation between balance sheet and cash flow statement in creative financial reporting

Manipulation of assets and liabilities in the balance sheet and cash flow in cash flow statement is "harder to detect and prevent in relation to manipulation with income and expenses in the income statement" (Dimitrijević, 2015, 137). The most common forms of manipulation that connect balance sheet and cash flow statement are: sale of receivables before the deadline, collection of fraudulent receivables from customers, accelerating the pace of debt collection, use of bank loans, "boomerang" transactions, reclassification of cash flows from operations with securities, slowing the pace of payment of liabilities, reducing the volume of inventory purchase, use of inflow from acquisition of all or part of the company.

When selling receivables, usually to a bank, the company pays a commission to reduce the amount of receivables sold. This type of sale is seen as cash inflow from financing activities. However, companies usually define this inflow as inflow from operating activities because they result from the sale of receivables resulting from goods supplied and services rendered. A characteristic example (SEC Report, 2007) for this type of manipulation is related to the US pharmaceutical distributor "Cardinal Health". This company had a problem with a lack of money, so it decided to sell a certain number of receivables on the basis of which it accumulated over 800 million dollars. The subject sale increased inflow from operating activities during 2004, which, compared to the previous year, was an increase of 971 million dollars. In this way, the company transferred inflows from the future into the present period, and thereby reduced future cash inflows from operating activities. "It is, therefore, important to, when analyzing inflow from operating activities, notice a sharp rise, and consider not only the amount of increase, but also the reason that led to this increase" (Dimitrijević, 2015, 146).

Another way to increase inflow from operating activities in the current period is through collection of false receivables from customers. Studies (Ketz, 2004) know of an instance of an American company “Peregrine Systems”, which presented false income in the income statement, as well as false accounts receivable in the balance sheet (based on which it allegedly realized this income). At the same time, the company sold these non-existing accounts receivable, thereby increasing its inflows in the cash flow statement. Bank purchased these receivables, but the risk of collection or non-collection of those debts was taken by “Peregrine Systems”. From an economic standpoint, it was a bank loan, because “Peregrine Systems” received the subject cash flow from the bank with collateral in the form of false receivables. Therefore, this cash inflow should be shown as inflow from financing activities, rather than as a cash inflow from operating activities.

There is also the possibility of time matching of fictitious purchase of equipment and fictitious receivables from existing customers (Mulford & Comiskey, 2005). Purchase of new equipment is presented in cash flow statement as outflow from investing activities, and an increase of receivables from the sale of products and provision of services as an increase in inflow from operating activities. Fictional inflow from operating activities and fictitious outflow from investing activities can be deliberately the same so the aforementioned transactions have no impact on the cash balance at the end of the period, but result in overestimation of net operating cash flow (Stevanović, Belopavlović & Lazarević-Moravčević, 2013, 32).

Presenting increased cash inflow from operating activities on the basis of regular bank loans is another in a series of cash flow manipulations. The American company “Delphi Corporation” in the fourth quarter of 2000 had a negative net cash flow from operating activities. In December of the same year, “Delphi Corporation” offered to the “Bank One” shares worth 200 million dollars for sale. The bank refused this offer, so “Delphi Corporation” offered the bank to purchase these inventories, and “sell” it to them again in a few weeks. In return, “Delphi Corporation” paid a certain amount to the bank, determined based on the sales value of inventories. In essence, this was a classic short-term bank loan. This method of lending in the cash flow statement should be recorded as an increase in cash flows from financing activities, and in the balance sheet as a liability to the bank. However, “Delphi Corporation” presented this loan as a classic sale of inventories to the bank, which increased its sales revenue in the income statement and cash inflows from operating activities in cash flow statement by 200 million dollars. In this way, “Delphi Corporation” presented in a 2000 cash flow statement a total of 268 million dollars of inflow from operating activities, of which only 68 million was real (SEC Report, 2006).

Overdraft is seen as a short-term bank loan, where cash inflow based on the use of overdraft and cash outflow related to interest payment, as price for the use of overdraft, are seen as cash flow from financing activities. A situation where overdraft is shown as inflow from operating activities in cash flow statement could lead to increasing net cash flow from operating activities.

By accelerating the pace of collection of receivables from customers, or through collection of receivables before deadline, the company can improve its cash flow. The American company “EDS” negotiated with their customers, and collected receivables in the amount of 200 million dollars, which were due in two years. In this way, in the current year, the company presented a sudden jump in cash flows. “From an economic point of view, higher collection of accounts receivable is certainly a good indicator. However, one should always be cautious in making conclusions, and investigate whether rapid collection is the result of successful business, or a form of fraud" (Dimitrijević, 2015, 148). The fact is that inflow provided in this way is the real source of funding provided by customers. Based on this, one can conclude that these cash flows should be presented as financing activities in cash flow statement. Nevertheless, these cash flows can also be viewed as cash inflows from operating activities, which is explained by the fact that the company has delivered or will deliver (if it comes to paying invoices prior to the delivery) products or services to customers.

Higher cash flows from operating activities can also be achieved through "boomerang" transactions (Dimitrijević, 2015, 146). These transactions mean that the company sells its products to other companies, but, at the same time, purchases a variety of products from these companies in the same amount. The impact of these transactions on cash flows is as follows: the company presents product sale as cash inflow from operating activities, while the purchase of goods is presented as outflow from investing activities. This brings double "benefits": reduced outflows and increased inflows from operating activities.

Under IAS 39, securities are classified as securities held for trading, securities available for sale, and securities held to maturity. However, there are no strict rules for the classification of securities. This flexibility allows accountants to, if necessary, reclassify cash flows by activities. If, for example, one invests in the purchase of short-term bonds, cash outflow for this transaction belongs to a group of investing activities. Purchased short-term bonds can be placed in a group of securities held for trading, aimed at exploitation of short-term price fluctuations of these securities. Cash inflows from sale of thus classified short-term bonds belong to a group of operating activities. This reduces net cash flow from investing activities (at the time of their purchase), and increases net cash flow from operating activities (at the time of their sale). The situation is different if the company's main activity is bond trading, i.e. if it is a financial institution. In this case, these activities should be classified as operating activities, otherwise such classification of cash flows should not be made. The reason, first of all, lies in the fact that this is not a sustainable cash flow, but inflow that appears only once (when sale transaction is made) (Đukić & Pavlović, 2014, 230-231).

Rise in cash flows from operating activities based on the slowdown of payment of obligations or delays in cash outflow intended for the settlement of liabilities is considered one of the easiest techniques to manipulate cash flows. For example, liabilities of December of the current year are postponed for January next year, and thus cash flow statement for the current fiscal year presents lower cash outflows. It is important to note that, in this way, managers achieve short-term goals, because liabilities cannot be postponed for an indefinite period of time.

Another way to increase cash flow from operating activities is to reduce the volume of inventory purchase. The company "The Home Depot Inc." in 2001 reduced orders from its suppliers, and purchased fewer inventories than in the past per each store, i.e. the company changed the pace of inventory purchase. In this way, the company reduced cash outflows for the purchase of inventories from 1.1 billion dollars in 2000 to as much as 166 million dollars in 2001 (Grow, 2007).

Acquisition improves cash flows of the acquiring company. In the event that the target company is purchased in cash, the acquirer presents it as outflow from investing activities, rather than from operating activities. If acquisition is carried out through shares, then there is no cash outflow. Also, any sale made by a target company is in the acquirer's financial statements presented as sales revenue or cash inflow from operating activities. However, the greatest opportunity to improve cash flow through acquisition lies in acquired receivables and assets (Dimitrijević, 2015, 147). When acquiring receivables and assets, there are certain expenses and cash outflows, incurred before acquisition. In other words, the acquirer has no outflows from operating activities related to acquisition of subject receivables and assets, as they have been incurred prior to acquisition. Following acquisition and collection of receivables and the sale of assets of the target company (acquired before acquisition), cash inflows are classified as cash inflows from operating activities of the acquirer.

Unrealistic results also come from some other creative activities of accountants or managers, such as: “giving up on certain business transactions, non-recording of incurred transactions, delaying procurement, non-recording of procurement of materials and goods, because invoice is not received or materials and goods are on the way, etc.” (Škarić-Jovanović, 2007, 63). The reason is largely subjective and linked to adverse effects (mostly from managers’ standpoint) on net cash from operating activities. The fact is that the amount of net cash flow as a whole, i.e. cash balance at the end of the reporting period, is not affected by manipulative actions of management. However, the above cannot justify the existence of creative cash flow reporting.

Amendments to IAS 7 aim to improve information on cash flows and disclosure, to help users of financial statements understand liquidity of an entity. The IAS Committee suggests that an entity should, in the initial and final balance sheet, disclose the balanced amount of each item whose cash flow is, or will be, classified as a financing activity in the cash flow statement, without the inclusion of capital items. The result of balancing the required amounts should disclose to investors important information regarding the entity’s debt and changes in debt structure during the reporting period. Also, the IAS Committee proposes to expand the disclosures required in IAS 7 on liquidity of entities and restrictions that affect the entity’s decisions to use cash and cash equivalents, including tax obligations, which would increase based on distribution of cash and cash equivalents generated abroad.

## CONCLUSION

“International financial reporting is a dynamic, evolving research area. Powerful new technology and communication devices make the world open to explosion in international trade and creation of capital” (Haskins, Ferris & Selling, 2000, 1). Loss of customer trust in the information presented in financial statements would have incalculable consequences for global financial market, and, thus global economy, because high-quality financial reporting is considered a basic assumption of stability and competitiveness of the global financial market.

Prevalence of manipulation in the presented financial statements depends on the situation in the economic, legal, and political environment, quality of financial reporting normative base, quality of corporate governance, and accountants’ abilities to comply with professional and ethical standards. Late $20^{th}$ and early $21^{st}$ century were a fertile ground for various manipulations in all financial statements. The biggest accounting scandals took place in that period and in the most developed country of the world, the United States.

“The importance of information that cash flow statement provides to its users increases the need for creativity in this area” (Đukić & Pavlović, 2014, 233). Successful company is the one that achieves positive net cash flow from operating activities in the amount of not less than the amount of the previous year, i.e. net cash flow from operating activities that is sustainable. After a certain period of time, manipulation with results, net cash flow from operating activities, and share price becomes evident, which decreases trust of shareholders, investors, and other stakeholders in the success of business. It is precisely for reasons of preventing manipulation, as well as adapting to new business conditions, that IAS corrections occur.

Reporting on changes in cash flows of companies and definition of requirements for the disclosure of information in cash flow statement are regulated by IAS 7 – Statement of Cash Flows. Improving standards that regulate cash flows is necessary due to the fact that without information on company cash flow it is not possible to make the right decisions and, thus, maximize business success.

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## KREATIVNO FINANSIJSKO IZVEŠTAVANJE O NOVČANIM TOKOVIMA

*Finansijski izveštaji treba realno da prikazuju finansijski položaj, uspešnost poslovanja i novčane tokove preduzeća. Kreativno finansijsko izveštavanje predstavlja smišljeno manipulisanje informacijama u finansijskim izveštajima radi stvaranja pogrešne predstave o efektima poslovanja preduzeća. Kreativni finansijski izveštaji su prvenstveno namenjeni investitorima, u cilju ohrabrivanja kupovine akcija preduzeća i time utiču na povećanje njegove tržišne vrednosti. Kreativnost u sastavljanju izveštaja o novčanim tokovima sastoji se u prekvalifikaciji aktivnosti iz poslovnih u investicione i finansijske aktivnosti i obrnuto.*

Ključne reči: *kreativno računovodstvo, izveštaj o novčanim tokovima, poslovne aktivnosti, investicione aktivnosti, finansijske aktivnosti*