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SIGNIFICANCE OF THE ACCOUNTING PARADIGM IN THE DECISION-MAKING PROCESS IN COMPANY MANAGEMENT (BASED ON IAS ACCOUNTING PRACTICES IN POLAND AND OTHER COUNTRIES)

LESZEK MICHALCZYK*

Abstract

In this article, we analyze the relations between modern trends in accounting and the decision-making process based on the classic profit-opportunity-cost-risk construction. In this aspect, four main types of accounting practices may be distinguished: bookkeeping (classic accounting), accounting engineering, creative accounting, and praxeological accounting. This study complements the author's series of publications on accounting engineering (which is herein defined as a concept), the structure of economic auxiliary sciences, and causal relations in management practice and theory based on Bertalanffy's general systems theory. The article covers accounting systems which emerged as a result of combining IAS solutions with domestic accounting standards and balance laws, and relates primarily to accounting theory and practice in Poland. Nevertheless, the Polish system is rooted in accounting solutions previously used in other countries, and as such may be perceived as more utilitarian, also on an international scale.

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INTRODUCTION

Thanks to the legal approval of creative accounting, company managers have an opportunity to exploit accounting solutions by means of which identical economic operations may be recorded in different manners so as to yield different financial results – a tool which will be used on an even larger scale in the future (in Polish accounting practice). Using such solutions may have disastrous economic consequences. Given the resulting information asymmetry and in view of the consistency principle, stakeholders will be unable to make any rational decisions with respect to the company if they base their decisions on the financial data it publishes. According to the consistency

principle, any profit „created” in a given period must result in a diminished financial result in subsequent accounting periods (other aspects: Michalczyk 2010a p.289-298, 2010b p.178-187, 2011a p.115-132, 2011b p.103-111, 2011c p.132-140, 2011d p.87-114, 2012a p.37-54, 2012b p.121-131, 2012c p.78-87, 2012d p.147-165, 2013 p.26-34). Such a situation may affect the stability of funds on the stock market, as well as that of credits and loans given to economic entities, and in the case of accounting engineering solutions applied to tax calculation it may additionally affect the amount of money collected by the State Treasury. Furthermore, all attempts to assess the efficiency of management in companies whose reported financial

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results are dependent on the choice of accounting variants are not credible.

According to the modern business management framework, optional variants afforded by the balance sheet law are exploited to meet the economic objectives of a company. This results from the legalisation of accounting procedures and alternative solutions which make it possible for entrepreneurs to tailor their companies' recorded financial results to influence (determine) the behaviour of stakeholders. The use of alternative accounting methods has been discussed in various studies throughout the world for at least 30-40 years under the name earnings management (such as - in classical versions: Beasley, 1996; Burgstahler & Dichev, 1997 p.99-102; Dechow & Skinner, 2000; Dechow et al., 1996; Degeorge et al, 1999; Fama & Jensen, 1983; Hayn, 1995; Healy & Wahlen, 1999; Leuz et all, 2003; Peasnell et al 2005;

Schipper, 1989, p. 92; Teoch et al. 1998a, 1998b – analysis f.ex. in: Michalczyk, 2013, p.26-34).

Polish companies focus not only on the consistency principle and using accounting to „create a profit”, but also on accomplishing current goals and „creating a loss” – particularly in national companies to be privatized (Michalczyk, 2010a). In the latter case, accounting methods are used to diminish the value of a company. Considering the absence of an open privatization market in Poland, such operations caused (and still do) hard-earned fortunes created by many generations' work to be sold „dirt cheap.” This practice is especially common in „Balcerowicz's” model of privatization whereby property is sold on an open market without holding a tender.

Table 1 presents methods and the extent of their influence on the temporary financial result.

Table 1: Elements of variant accounting affecting the financial result of a company

Balance sheet item	Influence on temporary financial result	
	in plus	in minus
Tangible fixed assets (i.e. capital assets)	Maximum costs of purchase activated in the value of a capital asset	Minimum cost of purchase, abandonment of the assessment of residual value
	Lack of write-downs due to permanent depreciation	Use of revaluation
	Linear methods, maximal period of use in accounting	Declining balance method, minimal period of use in accounting
Non-material and legal values	Goodwill - maximal period	Goodwill - minimal period
	Development costs - maximal extent of activation of production costs; lack of write-downs after the loss of economic value	Development costs - production costs equal to direct costs, write-downs after the loss of economic value
Tangible circulating assets (reserves)	Cost of purchase, maximal expansion of indirect allocated production costs	Cost of purchase, isolating groups of unjustified production costs
	If prices in this product line increase - FIFO; if they decrease - LIFO; use of fixed prices	Price increase: LIFO; price decrease: FIFO; use of fixed prices
	Limited amount and value	Maximized amount and value
Account receivable	Valuation according to present value (nominal value + interest)	Valuation according to historical value

Balance sheet item	Influence on temporary financial result	
	in plus	in minus
Accruals and prepayments (in analogy: reserves)	Maximal time of costs settlement	Including maximal costs as costs of the current period (also, resignation from creating prepayments*)
	In limited use	Maximal use
Agreements and long-term contracts	Percentage method	Completed contract method
	Lack of accreditation	Accreditation
Liabilities	Valuation in nominal value	Calculation of interest
Deferred income tax	Exploitation of all negative temporary differences	Adherence to the principle of prudence - exploitation of negative temporary differences whose probability to bring profits borders on certainty
	Considered	Not considered

Source: Own studies based on the Accounting Act

*the rationalization of accounting operations points to a need to create prepayments at least for those entries that affect tax settlement. Employing optimization of tax settlement in a business may mean that prepayments are recorded on the last day in the reporting period.

Below we present a classification of accounting paradigms currently used by companies in order to accomplish the objectives set by their managers.

KEY ASPECTS OF THE ISSUE

Apart from classic accounting aimed solely at recording economic activity, modern management frameworks distinguish between three main trends in accounting:

- 1) accounting engineering,
- 2) creative accounting,
- 3) praxeological accounting (current studies on the subject typically assume a „wide” view of creative

accounting. As a rule, if an accounting method chosen by a company seems „questionable”, it receives a label of creative accounting. A different interpretation, e.g. found in the works of Leszek Michalczyk (Accounting Practice in Poland), introduces a definitional split between accounting engineering and creative accounting).

Various accounting paradigms currently in use may be distinguished from each other by looking at how they relate to decision theory (Michalczyk, 2005a). Their key aspects are presented in Table 2. The table illustrates the differences between individual approaches through key factors associated with purposive decisions.

Table 2: Current concepts in accounting practice and criteria decisive in decision making

No	Category of analysis	Classic accounting	Modern accounting paradigms		
			Accounting engineering	Praxeological accounting	Creative accounting
1	Risk (here: legal)	None	None	Remote	Major
2	Reward (here: accomplishing company objectives)	Immaterial	Material	Immaterial	Material
3	Consequences	Material	Material in 1 or 2 subsequent reporting periods	Material for current activities	Immaterial
4	Certainty	Material	Material	Immaterial	Immaterial

Source: Own studies

The reason why accounting engineering should be distinguished from other trends in modern accounting is the fact that it minimizes the risk while maximizing the „reward”. The risk associated with modern accounting paradigms are as follows:

- 1) accounting risk – results from violating applicable provisions of the balance sheet and tax laws,
- 2) balance risk – dangerous to the company due to changes in its financial result in future accounting periods,
- 3) macroeconomic risk – associated with a possible „domino effect” initiated by accounting engineering solutions employed in previous reporting periods.

In accounting engineering, risk, understood as disregarding applicable provisions of the law, is a function going to „zero”. This is due to the fact that accounting engineering is, in definition, a lawful activity.

Balance risk falls beyond the scope of present and future reporting periods, and as such is not associated with accounting engineering. Nevertheless, one should remember that balance changes generated in a current period will be „compensated” in future periods. Generating a positive financial result by means of accounting „operations” will yield a diminished financial result in the future. Analogically, reducing the financial result will have the opposite effect in the long run.

While the concept of risk does not play a particularly important role in the decision-making process involved in accounting engineering, the notion of „reward” is very significant. In fact, „reward” is what

determines the character of actions undertaken under this paradigm.

Within the framework of accounting engineering, „reward” signifies:

- 1) accomplishing objectives effectively, the degree to which they are accomplished,
- 2) financial goals of accountants and managers.

This category refers to the role of accounting policy as an element in the business system.

Traditional accounting (bookkeeping), which today is used mostly by companies offering outsourcing accounting services, emphasizes the record-keeping and interpretative functions of accounting. According to the modern approach, activities playing an auxiliary role with respect to attaining economic goals of a company are redefined. In accounting engineering, accounting practice is seen as „shifting” from a traditional (passive) approach to a more modern (active) standpoint. Accounting’s participation in attaining company objectives produces a „reward” – the ability to actively influence a company’s economic activities.

Accounting engineering is therefore the definition of theoretically and legally suitable accounting activities. Accounting engineering makes use of the opportunities afforded by the balance sheet and tax laws with respect to the operations and, to a certain degree, the strategies of a company.

This relationship follows from the consistency principle and plays a part in every practical approach to accounting assumed by companies, with the exception of creative accounting.

In praxeological accounting and accounting engineering, economic activities may be recorded

„consistently” for a limited time. In the former case, this is directly connected with the economy of actions, and in the latter – with attaining company objectives. The „economy” of actions manifests itself in the general prevalence of the materiality principle, which is only applicable if the omission of particular economic events and operations in accounting records brings no material consequences. Accounting engineering admits the possibility of „purposeful” actions meant to modify the accounting policy of a company. Should this occur, the category of „certainty” is undermined. Such modifications are recorded only in the report for the period in which the changes were made. Additionally, the record of economic operations may be used in combination with operations based on a so-called fundamental error. As a result, the record of economic operations is „shifted” to future reporting periods.

The „certainty” category follows from observing the provisions of the balance sheet law. Hence, in a sense, „certainty” is an opposite of „risk”.

Accounting engineering presupposes absolute compliance with all applicable provisions of the law. Creative accounting (a „set” of actions performed by a „creative accountant” (Andrzejewski & Piński, 2002), on the other hand, consists in using descriptions, calculations and analyses incongruous with the kind of event or process that is being recorded (similarly: Uchwała...). The document provides that financial statements generated as a result of creative accounting: (1) are based on unreliable financial data, (2) do not comply with the balance sheet law or other applicable laws (here: stock exchange laws), (3) are intended to artificially improve the image of an economic entity). While both paradigms have the same purpose, they operate in different ways.

There are certain symptoms betraying the use of creative accounting:

- 1) lack of any material reason motivated by organizational changes in the company or the corporate group the company belongs to, as well as overly complicated mutual „investment” connections within the group, which often make it extremely hard to single out the parent company,
- 2) dramatic changes in balance sheet values or financial results, unless they are a result of implementing new technologies, entering new markets or acquiring cheaper factors of production (see more in: K. J., 2002).

Praxeological accounting exists „in-between” accounting engineering and creative accounting. According to the praxeological paradigm, a provision

of the law may be disregarded if it is impossible to comply with it for technical reasons. However, this „possibility” is evaluated with respect to the economy of actions (in this case: effect against cost of actions). As such, the economic aspect is perceived as synonymous with the technical one. Furthermore, praxeological accounting is an intermediate stage between traditional accounting (bookkeeping) and creative accounting. Praxeological accounting relies on the knowledge, skill and intellectual as well as physical (manual) competence of individuals working in accounting teams in the capacity of regular employees, controllers or advisors.

It is the knowledge and skills of these individuals that decide how, and whether accounting activities are used at all to attain the goals of a company. The greater their knowledge and skills, the greater the scope of accounting engineering operations in relation to creative accounting activities. This also means that one economic entity may use methods belonging to accounting engineering as well as those found in creative accounting.

Among modern accounting paradigms, only creative accounting is „the opposite of codified accounting” (Kutera et al., 2006, p. 38 – translation – LM).

In this article, however, we relate the notion of „creative accounting” to the entirety of the issue, i.e. disregarding the need for a separate definition (e.g. a semantic, conceptual one), with respect to those aspects which emerge from legally-sanctioned accounting activity herein referred to as accounting engineering.

Operations falling within the scope of praxeological accounting may be observed whenever theoretical regulations cannot be applied in practice due to their incompatibility with actual economic processes or phenomena. Accounting engineering sanctions only those actions which comply with codified accounting standards and are able to further strategic and operational objectives of a company.

Praxeological accounting consists in accounting activities which, in view of the absence of regulations applicable to certain economic operations of a company, create a true and fair view of the company (see more in: Sikorska, 2006, p.115-121, 2007, p.205-214).

With that purpose in mind, companies look for the most similar activities that are acceptable in accounting. Since no equivalents can be found in accounting practice, such operations cannot be

classified as accounting fraud. Where there is no rule regulating such activities, there is no possibility of error (including deliberate error, i.e. fraud). An error cannot be made if correct conduct has not been defined. In this situation, the notion of „fraud” is entirely subjective – instead of being based on facts, it is merely an „opinion.” As opposed to a „fact”, an „opinion” cannot be verified in terms of falsehood and truth.

A different approach can be found in the paper of M. Kutera, who writes that „creative accounting (accounting fraud – LM) is a reaction (...) to feeble norms, which, in certain cases, are unable to unambiguously define what needs to be measured and how” (M. Kutera, op. cit. p. 28 – translated: LM). Note that the problem faced by accounting has to do not with the measured item („what to measure”), but with the means („how to measure”). The nature of the measured item is a theoretical matter, and it would be an unnecessary complication if we were to consider it in terms of fraud. In practical accounting, the item is determined only by the codified part of accounting theory (or areas where a company has „full initiative with respect to accounting”). Each company is required to measure certain items, enumerated in applicable sections of the balance sheet law, which were present in a given reporting period or concern that period. This is one of the prerequisites necessary for a financial statement (together with any additional information) to be considered correct. If a company fails to measure some of the „items” specified in the statute, it may be accused of „accounting fraud”. However, such items may only be identified if one possesses sufficient knowledge in the field of accounting. Creative accounting as a practical endeavour cannot therefore be „a reaction to feeble norms concerning the measured item”. However if norms of measurement do not refer to a particular item or there is no connection between a „measured item” and „norms of measurement”, then simple logic dictates that such an item does not exist for the purposes of accounting, since it is not subject to measurement. Accounting is interested only in those elements of economic activity which may be measured in terms of money (i.e. in numbers). Additionally, in accounting, measured items are perceived as superior to the means of measurement. It is always the item and accompanying economic conditions that determine how it should be measured.

Which items are to be measured depends on the provisions of the balance sheet law. Theories which go beyond the scope of the balance sheet law are consequently irrelevant to accounting practices. They can be considered merely as suggestions of theorists addressed to practising accountants.

The difference between accounting engineering and praxeological accounting lies in the moment in which a given mechanism is implemented in a company. In accounting engineering, the financial result of a company is not left to chance. In the first place, the intended financial result is specified, and only then, in the next stage, mechanisms through which it will be reached are created. One such mechanism consists in choosing an appropriate accounting method. Any potential „surpluses” or „deficits” are „shifted” to future periods. As such, accounting engineering is an integral part of the budgeting process. „Surpluses” are recorded only if it was so established in the budget; otherwise, they are „shifted” (rolled) to other periods. „Deficits” are moved to future accounting periods.

Accounting engineering correlates with, among others, agency theory and, to a certain extent, theory of transaction costs. It also affects the quality and scope of economic information generated by a company, as well as influences the recipients (users) thereof.

What is at the same time evident is the problem of false information, half-truths and generalizations based on enumerative definitions contained in the balance sheet law. In this sense, the praxeological approach is controversial. Accounting engineering accepts praxeology only when a given activity lacks a legal definition. Thus, within accounting engineering, „inapplicable definitions” have a limited use. In this aspect, accounting engineering differs from the praxeological approach, which gives primary importance to the true and fair view, provided that its acquisition is economical.

CONCLUSIONS

Modern accounting paradigms resort to variant approaches, which may have an adverse effect on a company’s presence on the market. What is more, the legalisation of variant approaches is in conflict with the principle of protection of economic circulation, which is supposed to be the overarching objective of accounting (in more detail: Michalczyk, 2005c, p. 208-209; 2010a). Appropriate actions should therefore be undertaken to negate the effects resulting from the

fact that companies tend to adopt different accounting paradigms. For that purpose, accounting engineering should be presented as an element of the balance statement which allows one to make corrections of the current financial result corresponding to the value of changes that had occurred due to other accounting methods. Such a solution would also allow for a more

reliable evaluation of management quality, which is currently affected by the lack of objectivity in accounting paradigms, in which the choice of a final accounting method or asset and liability valuation methods influences the „performance” of an economic entity recorded in its financial statement.

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