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Possibilities of creative accounting avoidance in the Slovak Republic

Abstract. Creative accounting is a common phenomenon in recording the results in organisations. Act No. 431/2002 determines the need for the true and fair representation of economic results in Slovakia. In this article, the authors discuss the key assumptions of the audit in view of the financial audit application. Based at Slovak legislation, the authors present selected methods and possibilities of the creative accounting avoidance, which have a major impact on public finances in the form of taxes.

Keywords: Financial Accounting; Creative Accounting; Tax Evasion; Financial Audit

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Спосіб уникнення «креативного обліку» в Словачькій Республіці

Анотація. «Креативний облік» є поширеною проблемою щодо обліку результатів фінансової діяльності в організаціях. У Словаччині Актом № 431/2002 визначено необхідність правдивого її відображення. У цій статті розглядаються ключові питання аудиту з огляду на застосування фінансового аудиту. На основі законодавства Словачької Республіки запропоновано методи виявлення й уникнення «креативного обліку», який значною мірою впливає на стан державних фінансів.

Ключові слова: фінансовий облік; «креативний облік»; ухилення від сплати податків; фінансовий аудит.

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Способы предотвращения «креативного учета» в Словацкой Республике

Аннотация. «Креативный учет» является распространенной проблемой касательно учета результатов финансовой деятельности в организациях. В Словакии Актом № 431/2002 определена необходимость её правдивого отображения. В данной статье рассматриваются ключевые вопросы аудита с учетом применения финансового аудита. На основе законодательства Словацкой Республики были предложены методы определения и способы избежания «креативного учета», который в значительной степени влияет на состояние государственных финансов.

Ключевые слова: финансовый учет; «креативный учет»; уклонение от уплаты налогов; финансовый аудит.

1. Introduction

Financial accounting in Slovakia is regulated by Act No. 431/2002 Coll. on Accounting, as amended. The Slovak Republic, an EU member, implemented the Directives of the European Union into the national legislation. Accounting entities have an obligation to keep the accounts pursuant to the Accounting Act clearly and comprehensibly. Besides keeping accounts, the Act on Accounting defines the obligation for accounting entities to inventory their assets, and compile financial statements. In practise, there often occurs non-compliance of this Act, which may result in serious reduction in taxes on income from business activities in the state budget and thus the overall functioning of the financial policy distortion.

Theoretical foundations. Generally, creative accounting means a distortion of accounting information and non-compliance with the above mentioned Act on Accounting. (Espsten, Mirza, 2003) [1, 65]. Accounting entities often use a variety of practices and creative accounting mainly for the reasons mentioned in Table 1.

Tab. 1: Reasons and means of the creative accounting usage

Reasons to use creative accounting practices	Means of using creative accounting
Bank loan application of the accounting entity.	Increase of profits, reporting of the positive equity capital causing an increase in liquidity and profitability.
Mandatory registration of VAT according to the Law (§ 4 of the Act no. 222/2004 Coll. On Value Added Tax, as amended) [2].	Decline in the turnover for the purpose of compulsory registration of value added tax - for the accounting entity.
Reduction of their own tax liabilities for the value added tax (§78 of the Act no. 222/2004 Coll. On Value Added Tax, as amended) [3].	Application of the deduction of VAT on purchases, which the Act on VAT does not allow.
Reduction of any taxes on corporate income tax.	Increase in the costs of the accounting entity, including the costs not foreseen by the Law on income tax.

Source: Authors' processing

This may cause losses in the Treasury and, therefore, it is essential to focus on the creative accounting practices in order to detect them.

The most common definition, which appears in the literature refers to creative accounting as a process of manipulation of accounting data to transform the accounts of what form they should have in the form of what their creators would like to have. (Naser, Kamal, 1993) [4, 63]. The most common creative accounting practices can be illustrated by the following Figure 1:

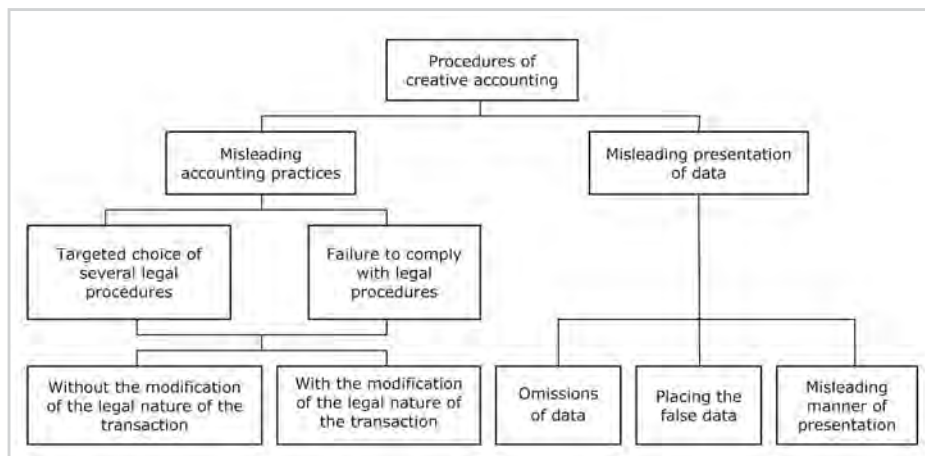


Fig. 1: Procedures of creative accounting
Source: Authors' processing

Application analysis of creative accounting in practice. Based on the long-term examination of the use of creative accounting practices, the following practices are most frequently used:

A) Targeted choice of several legal procedures:

1. Depreciation of property. Tax and accounting depreciation is controlled by two separate laws. Tax depreciations are definitely determined, while accounting depreciations are managed by the accounting entity itself according to the actual depreciation of assets. Creative accounting is reflected in the application of depreciation. Tax depreciation may be interrupted by the entity, which means that the entity does not apply them in the costs. Hence, accounting depreciation cannot be interrupted, and the entity has a duty to apply them in costs, while under the legislation the costs are deductible only as a tax depreciation.

2. The choice of the amortisation of intangible assets. Intangible assets are depreciated according to a depreciation plan by the accounting entity. The Accounting Act only provides a maximum period of amortisation of intangible assets, which is the cost of development, for five years. Accounting entities are obliged to write off given intangible assets no later than five years after their inclusion, while accounting amortisation of intangible assets is a tax deductible cost. Creative accounting is reflected in the fact, that the entity may itself determine the period of amortization of intangible assets and thus tends to increase legal costs.

3. Technical improvement of fixed assets means expenditures on finished extensions, additions and structural modifications, reconstruction and modernization, in excess of the individual tangible and intangible assets of 1,700 EUR for the taxable period. The form of creative accounting is reflected in the decisions of an entity to apply these expenses directly to the costs /501 Account/, or to increase the value of assets and costs reflected in depreciation /551 Account/.

4. Application of expenditures in the cost of tangible fixed assets. If an entity procures fixed assets on credit, it is required to pay the interest. The creativity of the accounting entity is reflected in the alternative decisions, whether to include the loan interest into the costs, or to account them directly to expenses. If the entity charges the interest as a cost, it can legally raise the costs. If it decides to include the interest into the cost of

fixed assets, the amount of interest will be gradually applied in the costs of accounting entity in the form of depreciation.

5. Deduction of tax losses is also an alternative tool for creative accounting. It is a means of reduction of the tax base on corporation tax. An accounting entity can deduct the tax loss uniformly over the four consecutive tax periods, if the entity recognises the tax base. Accounting entities use this method of tax relief, if they are interested in the reduction of the tax.

B) Failure to comply with legal procedures

1. Depreciation of fixed assets. In order to avoid the raise of the income tax base, accounting entities interrupt the accounting and tax depreciation of assets, which is in contrary to the law, and thereby they reduce their own income tax, which should be paid to the State. Thus, they use the illegal practices of creative accounting.

2. Adjusting entries. An accounting entity has an obligation to create, in accordance with the precautionary principle provisions, if it is essential to assume, that there was an impairment of assets compared to its appreciation in the accounting. If there is an adjusting entry arising from the law on income tax, then the creation is a tax deductible expense. When it comes to other provisions, then such an accounting entity has an obligation to increase the income tax base.

The signs of creative accounting appear when the entity does not form any adjusting entries, but distorts the real value of assets, which is calculated in the balance sheet.

3. Reserves are formed by accounting entities on the basis of the precautionary principle for risks and charges. Reserves are divided into: law arising, from the Law on Income Tax (then they represent a tax deductible expenses), and other reserves (which represent unrecognised tax expenses). Creative accounting will be reflected if the entity does not create a reserve that belongs to other reserves category and wrongly qualifies lower tax on corporate income tax.

All of the selected aspects form tax evasion. Tax evasion is a result of the overall economic behaviour of taxpayers, oriented to reduce the tax liability of the taxpayer to the state on legal, or illegal basis. In its core, tax evasion is either legal or illegal tax avoidance, both within the country and internationally. *Legal tax avoidance* is understood as a tax evasion, in line with the current legislation. This method is characterised by tax avoidance by clever use of possibilities offered by law (Burak, 2011) [5, 16]. In practical application of creative accounting, it is a targeted choice from several legal procedures. Thus, the entity does not commit a breach of current legislation, but selects the most appropriate alternative offered by law. *Illegal tax evasion* means breaking the law. With regard to creative accounting, it is a violation of legal procedures. The most common examples of illegal tax evasion are:

- companies established solely for the purpose of billing (white horses located on the so-called virtual addresses);
- invoicing which, on the one hand, is not recorded in the books and is not accorded to the tax return, on the other hand, it is when a customer deducts a VAT of it;
- falsification of accounts;
- exchange of invoices in accounting;
- failure to creating the invoice for the sale of goods, or services and the failure to use electronic cash registers,
- taxpayers' claims to deduct VAT 2 times,

Costs and VAT deduction is applied from «bought blocks» of an electronic cash register.

To illustrate the seriousness of the problem, we have processed selected data from the following areas:

We can see from the Table 2, that the worst, in terms of tax evasion, was the year 2013, when the highest value was the

Tab. 2: Summary of tax evasion detecting in the period of 2012-2014 in Slovakia, in thousands of Euros

Type of tax	Year 2012	Year 2013	Year 2014	Year 2015
Additionally assessed tax from the taxes on corporate income tax	122,563	142,007	57,713	57,954
Additionally assessed tax from the taxes on VAT	173,015	241,878	194,305	193,542
Fine for improperly kept accounts	431	241	225	242
Together	296,009	384,126	252,243	243,572

Source: Annual Report of the Financial Directorate of the Slovak Republic 2014 [6]

Additionally assessed tax from the taxes on VAT. In 2014 the values decreased substantially and they were about 60% compared to the value of 2013.

In 2015, the state focused on intensive checks and legislative underpinning of cases and so the result for the year 2015 will be even more favourable. But there is even the other side of things, which is a leakage of financial means at the expense of the mother country of entrepreneurs.

As the Slovak Republic intensively fights against the tax evasion, businesses are looking for ways to avoid detection, so they often locate their activities and income to taxation in tax heavens. Tax heavens are attractive, because they offer extremely low tax burden on income.

As we can see from Table 3, tax heaven has a wide variety of countries. Slovak entrepreneurs use them mainly for the next reasons:

- high tax burden,
- frequently changing laws and legislative regulation regarding the taxation and business.

Interest in business abroad is growing, especially in offshore tax havens where it is easy to set up a company and accounting is conducted according to the laws of that country. There are even more companies that provide the establishment of business companies in the tax heavens.

Detection of tax evasion

The International Standard on Auditing 240IAS is provided in the process of auditing of creative accounting practices (Soltani, 2007) [7, 42]. This standard is called «The auditors' responsibility for examining of the fraud in an audit of financial statements». The standard clearly defines the term «fraud» as a deliberate action of one or more persons engaged in management, persons in charge of the governance, employees, or third parties involving the use of lies to gain an unfair or illegal profit (IFAC, 2007) [8, 164]. It is essential for the auditor to consider two types of international misstatements: an inaccuracy

resulting from fraudulent financial reporting and inaccuracy resulting from theft of assets. A low level of financial and economic appraisal solutions in the sphere of elaboration and implementation of fiscal policy leads to new expenditure. (Bogolub Tetyana, 2013) [9, 60].

Introduction of the measures against tax evasion is the current issue both in the EU member states and even in the Slovak Republic. In accordance with the International Accounting Standards IAS 240, the Ministry of Finance prepared a document entitled «The Action Plan for Fighting the Tax Evasion» (Babca, 2012) [10, 23]. In 2015, the approved action plan included the following measures:

- mandatory electronic archiving of accounts, including records of value added tax;
- establishment of a system for monitoring cross-border transport of goods, the so-called Electronic Transit Control System (ETCS);
- introduction of a system of sending automatic notifications by SMS to tax debtor;
- presentation of information about tax debtors on the website of the Financial Administration of the Slovak Republic in order to reduce tax arrears;
- introduction of the possibility of cancellation of trade licenses for infringements of the provisions of Law No. 431/2002 Coll. on Accounting, as amended;
- introduction of the criminal liability of legal persons;
- analysis of the possibilities of information exchange including electronic cooperation between the Financial Directorate and all banks;
- introduction of online access of Financial Directorate of the SR into the Toll system (interconnectivity) in the CEMVO register (Central Registry of Motor Vehicles) and in the Register of Individuals.

The auditor is responsible for the detection of material misstatements. (Zubaova, 2008) [11, 135]. There exist the following means to detect tax evasion:

- professional skepticism when the audit envisages tax evasion, even in the case when there is no tax evasion;
- obtaining information from management, internal auditors, and other persons in the entity, to determine whether they have knowledge of the real, alleged fraud, or suspected fraud (for example, a written statement from a lawyer of an entity, information from managers, information obtained directly from the banks and the subsequent request for account numbers and closing balances until 31 December, of the audited accounting period);
- analysis of accounting entries of the accounting entity;
- a written declaration of the management, which includes, among other factors, the statement that the given accounting books and financial statements are free of material misstatement, or omissions.

The Slovak Chamber of Auditors has a competence to control the work of auditors as well as their progress in detecting tax evasion. If the investigation shows serious violations of international auditing standards and the relevant legislation, the Slovak Chamber of Auditors has a right to suspend the license of the auditor.

5. Conclusion

Creative accounting results in reducing the tax liability of financial entities and, consequently, budgetary revenues. For this reason, creative accounting is closely related to tax evasion. Tax evasion occurs not only in Slovakia, but also in the countries of the European Union. In Slovakia, the total

Tab. 3: Number of Slovak companies with the owner in a tax heaven

Country (tax heaven)	Number of Slovak companies with the owner in a tax heaven			
	2012	2013	2014	2015
Bahamas	7	15	13	13
Belize	96	117	114	107
British Virgin Islands	78	88	101	101
Gibraltar	7	8	16	14
Hong Kong	30	35	36	36
Jersey	16	13	10	9
Cayman Islands	3	6	4	5
Cyprus	767	755	750	740
Liechtenstein	28	32	36	36
Latvia	44	49	69	63
Luxemburg	392	354	393	392
Malta	45	54	83	92
Marshall Islands	2	2	2	5
Monaco	18	21	24	21
Netherlands Antilles	4	3	3	3
Netherlands	1110	1124	1154	1137
Panama	62	94	158	169
Seychelles	180	220	205	190
United Arab Emirates	41	53	67	71
United States of America	760	859	1028	1029
Together	3690	3902	4266	4233

Source: Authors' processing according to the Statistical Office of the Slovak Republic

amount of tax evasion in 2011 was 2.773 billion EUR. According to statistical data of the European Union, the largest tax fraud in 2012 were in the value added tax in the amount of 117 billion EUR.

The Slovak Republic is fighting tax evasion by taking appropriate measures to reduce tax evasion. The fight against tax evasion is also performed by the Financial Administration and also by individual auditors.

The Financial Administration annually improves the system of tax controls. Such improvements are related to modern approaches to control activities, and organisational management

controls. Auditors have been obliged to notify the authorities of prosecuting tax evasion if it is of a criminal nature.

The fight against the tax evasion is an ongoing process, because tax evasion is a permanent malady that exists in the market society. Thus, to increase the budgetary revenues, great attention should be paid to the state of budgetary revenues.

It remains an open question, how to stabilize the business environment and how to establish a reasonable level of tax burden for countries so that tax heavens ceased to be attractive to business and businessmen were interested in promoting their activities in their own states.

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