FIGHTING THE ENEMY OF FAIR VIEW PRINCIPLE – GETTING TO KNOW CREATIVE ACCOUNTING

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Abstract

In this paper, we aim to discuss the role of creative accounting as a technique of accounts manipulation in contrast with the fundamental principle of accounting – fair view presentation, and the ethics of the accounting profession. In order to do so, we review the opinions of various authors on the subject while contrasting both fraud and professional ethics with creative accounting, and explaining the inverse causal relationship that arises between creative accounting and fair view principle. Further on, we determine what the role of auditors and corporate governance is in winning the fight over this kind of accounting practices. The study of previous literature is meant to be the basis for some possible comprehensive solutions we put forward that, from the point of view of accounts manipulation, would help achieve the transparency and trustworthiness that financial reporting deserves. When we propose these solutions, our main focus is on Romania. However, by extension, they could be applied anywhere else.

Keywords: creative accounting, accounts manipulation, true and fair view, professional ethics.

JEL classification: F32, M41
1. INTRODUCTION

It has been shown that accounting provides for 46% to 50% of the information needed to run a company [1]. However, accounting provides information not only for the insiders, but also for the outsiders, for those who have an interest in the company. The categories of users of accounting information are well-known to those with a basic knowledge in accounting and are not hard to guess by the others. In this paper, our focus is on how information provided by accounting affects external users, and mainly on how and why distorted information gets outside of the company into the hands of unsuspecting users.

The reference for deciding whether information is distorted or not is, in the case of accounting, true and fair view principle. We aim at discussing the role of creative accounting, one of the ways used to manipulate accounting information, in contrast with the meta-principle of accounting. As we will see further on, none of these two concepts is or can be clearly defined. One of the reasons may be that both are meant to express such a great deal more so that one cannot define them without leaving something out. We explain that there is an inverse causal relationship between true and fair view principle and creative accounting, although there is at least one opinion expressed in literature that is on the opposite side [2]. Another point of view over creative accounting that we will assume is the ethical one. By comparing creative accounting to accounting fraud, we intend to explain that there is some ethics in creative accounting, although it has serious gaps. The desired outcome of this paper is a set of solutions that, at least from the point of view of manipulated information, will help achieve the transparency and trustworthiness that financial reporting deserves and is expected to deliver.

Two points are bound to be made at this time. First, we are not interested here in how creative accounting is achieved, there is a handful of books on that (for example, “Financial Numbers Game – Detecting Creative Accounting Practices”, by Charles Mulford and Eugene Comiskey, “Uncovering Creative Accounting”, by Kevin Amor and Alan Warner, to remind just a couple), and when we come up with something new, we will write our own book. And second, we are not, nor do we claim to be the only ones proposing solutions to fight creative accounting, as we will detail further.

The remainder of this paper proceeds as follows. We ask what is true and fair in creative accounting, whether there is ethics in creative accounting and if creative accounting can be considered fraud. In the end, we present our set of solutions, accompanied by the underlying motivations that support each of them. The main methodological tool we use in this paper is literature review, aided by comparison and document analysis.

2. WHAT IS TRUE AND FAIR IN CREATIVE ACCOUNTING?

According to Financial Accounting Standards Board, accounting is an informational system that quantifies, analyses and transmits financial information about an economic entity [3]. The financial information is meant to be available to anyone who has an interest in it. However, because those who produce financial information know what interest each of the users has, temptation to alter the information so that it will meet the expectations of various users is great. Messing with accounting information is nothing new, as many researchers emphasize [4], [5]. But defining it is a whole different story.

Every article or book that we have gone through for the purpose of this paper has its own working definition of creative accounting. Definitions range from anecdotical-inspired
ones: “allowing the desire for a particular answer to adversely influence objectivity and to justify the choice of inappropriate accounting methods” [4], to very tangled ones which attempt to catch the sun in a cookie jar: “accounts manipulation [...] is the use of management’s discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of capital), or managers (compensation plans)” [5]. Basically, “the term creative accounting became a popular euphemism for non-standard accounting practices involving novel ways of characterising income, assets and liabilities” [22]. Indeed there are elements of unity among all the definitions, but there are elements that differentiate them, as well.

Also, another particularity of the subject stands out. There is no clear agreement on the term used to name these practices that alter accounting information according to someone’s desire. Many authors use the term “creative accounting” to refer to all the practices and techniques employed by managers and accounting professionals to change results and modify performance of companies [2], [4], [6], [7], [8], [22]. Others, mostly Asian researchers and Americans, prefer “earnings management” [9], [10], [11], [19], [24], while there are some who use the term “accounts manipulation” [5].

Amor and Warner use the expression “creative accounting” to refer to everything that is less than the true and fair view of the financial reporting of a company [2]. Under the umbrella of “accounts management”, Stolowy and Breton include a list of techniques such as earnings management, income smoothing, big bath accounting, creative accounting and window dressing [5]. Roughly put, these techniques represent inappropriate accounting methods chosen for different reasons [13]. Unlike Amor and Warner, Stolowy and Breton see creative accounting as one of the possible techniques of accounts manipulation. Though they state there are differences between these techniques, the authors do not clearly delimitate all of these techniques from each other. For example, they say that creative accounting is a technique of accounts manipulation, without adding what makes it particular.

In our opinion, lexical differences add little value, but are necessary in order to make it clear that we are all talking about the same thing. In this respect, we adopt the expression “creative accounting” to refer to everything that is less than the true and fair view of the financial reporting of a company. Under the umbrella of “accounts management”, Stolowy and Breton include a list of techniques such as earnings management, income smoothing, big bath accounting, creative accounting and window dressing [5]. Roughly put, these techniques represent inappropriate accounting methods chosen for different reasons [13]. Unlike Amor and Warner, Stolowy and Breton see creative accounting as one of the possible techniques of accounts manipulation. Though they state there are differences between these techniques, the authors do not clearly delimitate all of these techniques from each other. For example, they say that creative accounting is a technique of accounts manipulation, without adding what makes it particular.

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We have already mentioned that true and fair view, though a largely accepted principle, is not clearly defined and there is no unanimously accepted definition [4], [15]. The definitions given in literature by various authors to this concept could be grouped, according to Kirk [15], in two categories. Firstly, there are those who define true and fair view by defining each component – “true” and “fair”, neither of which are easy to define, by the way. Secondly, there are those who explain true and fair view in terms of “generally accepted accounting principles rather than accepting the concept as an independent quality” [15]. As Lee puts it, a company is giving a true and fair view through its financial reports when it respects both the word of law and its spirit [16]. Though there are many interpretations, it is acknowledged that true and fair view expresses the responsibility of company management and auditors to show the correct financial position of the company [4].

There is almost worldwide consent that the purpose of financial reporting is to show a true and fair view of the company to the outside users of information related to the company. A true and fair presentation is the most important task for those who prepare financial statements. In the anglo-saxon accounting system, this principle is valued more than any
other. In fact, accounting regulations ask that if the true and fair view cannot be achieved by respecting and applying existing standards and regulations, these should be put aside and other accounting treatments that will ensure a true and fair view must be applied. Therefore, it obliges management and auditors to “use their judgement when assessing the impact of accounting practice and, if necessary, allow them to overrule technical issues and legal niceties” [4].

This leaves room for a question that Amat, Blake and Oliveras speculated upon: “Is true and fair view part of the problem or part of the solution?” [2], does it open large doors for creativity or not? As these authors and others [4], [7], point out, the request for a true and fair view implies valuing professional judgement over obeying accounting rules and regulations. This would work marvelously well in a perfect world. In our imperfect world, however, this is just one huge door pushed open for those who want to benefit from what is on the other side more easily.

Professional judgement is regarded as “critical to the implementation of principle-based standards” [12]. In the light of this view, one would suppose that all major accounting scandals happen in principle-based accounting systems, that is the European countries. Reality contradicts this, and shows us that the accounting scandals everyone in the world knows something about happen in the US, which has a rule-based accounting system. Amor and Warner support the view that proper application of fundamental principles would significantly reduce the potential for creativity [4], while Nobes suggests that true and fair view principle, and therefore all fundamental principles of accounting, mean different things and have different effects according to time and place [14]. He explains this through the principle’s organic relationship with practice, although it is intended to be an “independent concept” [14]. On the other hand, simple accounting rules like “the lower of cost and net realisable value” are in practice a minefield of judgement [4], and Baralexis finds that detailed accounting regulation alone cannot solve the problem [7].

In order to fundament their decisions, users of financial information need to see the reality of assets, liabilities and operations in the financial statements of companies. Accounting theory and practice have shown that, at least for now, obtaining an absolutely true and fair view of a company through its reports is almost impossible, even when we presume the good faith of those who present the reports. Often, however, cases of less than true and fair accounting are made public. And this is not a new phenomena [4], [5], [7], in fact some would argue that it is pretty generalised [17]. Having in mind one or more reasons from a wide range, managers and accounting professionals choose to make use of various techniques and instruments of creative accounting that allow them to present the financial position and performance of the company in a better light. Consequently, the image shown to the public is more or less distorted, and is not in any way true or fair. It can be concluded, so far, that because of the consequences it has, creative accounting is an enemy of true and fair view. These two concepts are in an inverse causal relationship. In other words, creative accounting is what stops true and fair view principle from being achieved. The more creative accounting techniques we use (recognizing premature or fictitious revenue, aggressive capitalization and extended amortization policies, misreported assets and liabilities, getting creative with the income statement, problems with cash flow reporting [8] and so on), the further we get from a true and fair view and viceversa. Graphically, this could be expressed as in Figure 1.

There is at least one contrary opinion in literature. Amat, Blake and Oliveras opine that true and fair view principle itself “enhances the problem of creative accounting”
[2]. Their arguments are based on the fact that true and fair view could imply overriding accounting laws and regulations, therefore “increasing the opportunity for accounting policy choice” and that it encourages companies to disregard recommendations made by professional accounting bodies when choosing accounting policies [2]. It is not a perspective we agree with. And this is because there is a question of intention, as well. If companies were making accounting policy choices with the best of intentions and good faith, the result would be a true and fair view of that company, because “proper application of fundamental principles would significantly reduce the potential for creativity” [4]. When the intentions are less honourable, we get a distorted image of the company, the image someone desired us to see, rather than what we should really see. They support limiting the options of accounting choice by reducing the number of permitted accounting methods or by specifying circumstances in which each method should be used. Therefore they are for “drafting rules that minimize the use of judgement” [23] and dropping true and fair view principle. Such a view is an impractical one since it is not possible to define detailed rules for every line of business. Rather than that, we support raising ethical awareness on the problem.

![Diagram showing the inverse causal relationship between creative accounting and true and fair view](created_by_authors)
Visualizing the multiple contradictions between these two concepts enables us to speculate that the fight against creative accounting techniques, of limiting their effects, is the fight for true and fair view. Instantly, a question arises: what can be done in an effective manner to limit or even eliminate, where possible, creative accounting? After considering ethics and fraud in order to give wholeness to the concept of creative accounting, we will try to provide some answers to this question.

3. IS THERE PROFESSIONAL ETHICS IN CREATIVE ACCOUNTING?

Taking into considerations its consequences mentioned so far, it can be affirmed that creative accounting is a challenge for the accounting profession. In practice, the situations in which under the pressures of the management, the accounting professional applies a certain accounting treatment permitted by laws and regulations, but which intentionally shows a different image of the company than the true and fair one, are countless. The accounting professional is forced to balance ethics, accounting principles and his job.

Because one of the trademarks of the accounting profession is taking over the responsibility of acting in the best interest of the public, ethics should be above everything else for someone choosing this career path… in a perfect world, of course. In our world, however, high-profile accounting scandals make shareholders and analysts less reliant on reported figures and less trusting of audited accounts [2], making them doubt the ethics of this profession in general. Moreover, “manipulating the accounts is misleading the society as a whole, not just the shareholders; it leads to sub-optimal allocation of resources and, consequently, wastage of resources” [5] because “unethical behaviour often imposes a cost not only on the victim and the wrongdoer, but also on countless others” [22]. So much for the responsibility towards society!

Since creative accounting is at the limit of the law, Amor and Warner argue that creative accounting becoming too creative is a “question of degree”, that there is a “fine line between acceptable earnings smoothing and outright manipulation” [2]. Most techniques employed by creative accounting are “common place and usually acceptable as long as it is not part of an intention to deceive over the long-term” [2].

There are some who denounce the fact that some business schools teach creative accounting [22] saying that such a thing should not be done. On the contrary, our opinion is that people cannot protect themselves against what is bad unless they are told or taught what the bad thing is. We do agree, however, that creative accounting should not be taught with a positivist approach to it, but rather with a negative one, perhaps under the form of forensic accounting, that would deter future professionals from dirtying themselves with such actions.

In his doctorate thesis, Greenfield Jr. argues that a more relativistic ethical orientation (not so ethical, that is) increases the likelihood that creative accounting behaviours will occur, while the converse is also supported where a more idealistic ethical orientation decreases the likelihood that creative accounting will occur [24]. The results of this research indicate a significant relationship between an individual’s ethical orientation and their subsequent judgement.
4. IS CREATIVE ACCOUNTING FRAUD?

To better understand what creative accounting is about, we consider it useful to mirror it to fraud, more precisely accounting fraud. Fraud occurs when somebody commits an illegal act, for example fabricating false invoices to boost sales figures, falsifying or altering documents, deleting transactions from records, recording forged transactions, concealing significant information is fraud, while interpreting consignment sales as ordinary sales is an error [5]. Creative accounting techniques can be called aggressive accounting practices, but they are not fraud [18]. A clear distinction between creative accounting in the ordinary course of business and earnings fraudulently managed in a deliberate attempt to deceive the financial community is required because the accounting profession and regulators acknowledge that some earnings management techniques are not fraudulent.

Creative accounting is not against the law. It operates “within the letter both of the law and of accounting standards, but it is quite clearly against the spirit of both” [20]. It consists of “rule-bending and loophole-seeking” [21]. Many accountants, analysts and investors believe that good business practice requires managers to manage earnings. It is true, though, that most of the famous fraud cases in recent years have “started out with earnings management schemes designed primarily to smooth earnings” [19].

Figure no. 2 Factors within a company that facilitate “creativity” (adapted from [6])
Creating an “altered impression of a firm’s business performance” [8] is possible thanks to a complex of at least three factors that are best described graphically in figure 2 above. As figure 2 shows, a poor corporate governance is a leading factor that allows creative accounting to crawl in, together with a weak internal control and a lack of honesty and transparency in presenting the company’s performance. According to Ramaswamy, recent corporate accounting scandals resulted in an “outcry for transparency and honesty in reporting” [6]. Following this demand, corporate governance has started to become more shaped and more involved with the company than before. Auditors are also becoming more vigilant. And there is, indeed, need for them to be so since the simplicity of some creative accounting techniques can go unnoticed [5].

5. HOW CAN WE FIGHT CREATIVE ACCOUNTING?

It is widely agreed that creative accounting is a deceitful and undesirable practice [17]. Professionals also acknowledge that creative accounting differs from one country to another in terms of scope and underlying motivation [7]. But regardless of scope or motivation, creative accounting departs information provided by accounting by its most elementary characteristic: truth and fairness. The first part of our paper explains precisely this. Reviewing the literature has helped us come up with some solutions that could help achieve the transparency and trustworthiness financial reporting deserves. As we have pointed out earlier in this paper, we are not the only ones trying to find solutions to this nagging problem. Every researcher that has written about creative accounting provides one, two or more solutions of his own. By bringing a fresh look into the matter, our goal is to select those solutions provided by others that are most practical, and to put forward for discussion some of our own. We recognize the fact that creative accounting has been a long-lasting problem, and that it may never be completely eliminated [4], [5].

The first of the solutions we propose is that financial statements should always contain cash flow statement. Without getting into whether accrual accounting is more susceptible to suffer from creativity than cash accounting, we agree that cash flow is a good indicator of financial statements that have been “messed” with [4], [5], [8]. Analysts regard it as a good long time check on the validity of the balance sheet and income statement [4]. Therefore, one of the solutions proposed is that financial statements should contain the cash flow statement as well, no matter how small or big the company is. First of all, Romanian accounting regulations ask only big companies (those who exceed two of three criteria shown in OMFP 1752/2005) to include the cash flow statement as a component of their annual financial statements. But, as research shows [25], there is a higher likelihood of “messing” with financial statements in companies where founders have great influence on the Board of Directors. Moreover, Peasnell et al find a significant negative relationship between the number of non-executive board members and the scope of the manipulation, highlighting the importance of having external administrators on the board [28]. Therefore, if we narrow down these results at Romania’s level, all small companies which are managed by the owner are very likely to use creative practices for various purposes. Second of all, if revenue is properly recognized, cash flow should closely follow revenue recognition, theory says [4], [8]. Cash flow lagging significantly behind revenues could be a sign that companies are inflating revenues by recognising sales in inappropriate periods, making sales to noncreditworthy customers or recording fictitious sales [19]. This is why our position is that...
all companies should be asked to include cash flow statement into their annual financial statements.

Another thing regulators could do is to put a greater emphasis on consistency principle. The law should clearly put a mark on this principle since it is considered as one of the most effective controls on creative accounting [4]. Many specialists support the writing of rules that minimize the use of judgement [2], [17], [23]. Rather than that, prescribing consistency should also do the trick, without taking the beauty of the profession – rational judgement -, out of it.

Such requests are without purpose unless investors and auditors are more vigilant and ask the right questions [4], [19]. Some authors talk about “unsophisticated users” and, at least partially, blame them for the fact that creative accounting is still thriving [27]. Even stockbroking analysts were found not to adjust their financial analysis directly to take into account creative accounting in financial statements in a study conducted in the early 1990s [21]. Amat also shows that in the late 1990s banks were not taken aback by creative accounting even though it was explicitly pointed out at [2]. Probably the situation has changed by now, but we are not aware of a study that reconsiders this. Because publicity surrounding all major corporate accounting fraud scandals makes key areas of creative accounting in particular sectors more widely known managers should become more cautious in their approach to accounting [4] and users of financial information more skeptic and vigilant.

Professional bodies have a lot to say in this matter, too. If managed correctly, professional accounting bodies can be powerful enough to have some control over their members and considered to be reliable enough to be contacted by those who suspect creative practices. Besides this, a more convincing implication of professional bodies in shaping the ethics of young professionals could appear as useful because in the end, it all comes down to people. If a manager is determined to manipulate the results of the company by creative accounting, he will usually be able to do so in the short term [4], regardless of everything else. Professional accounting bodies should also be the ones to take initiative in strengthening the ethical code and assuring the suitable application of all its provisions, including sanctions.

Reaffirming what we mentioned earlier about business schools teaching creative accounting, we suggest that forensic accounting be taught in order to make all accounting students aware of the dangers of getting involved in such practices and of how to detect the application of such techniques. Teaching them creative accounting with a positivist approach to it is against our desired outcome, while not teaching them at all, leads to quite the same thing.

Solutions against creative accounting could be separated according to who should implement them. Two big categories arise from this classification: solutions that are to be implemented by the government, professional bodies or other interested parties, and solutions that are up to the company itself to implement. So far in this part of the paper we discussed possible solutions that fall into the first category.

From the standpoint of the company, there are a lot of things that could be done to prevent the application of creative accounting techniques. The first one would be to tackle reality as it comes and the management to simply say “no” to creative accounting practices. A sound management’s philosophy of ethical behaviour combined with strong corporate governance policies should create an environment in which ethics is valued above everything else. Together with strong procedural controls that provide for safeguarding the assets, proper authorisation, audit mechanisms and proper documentation, the company should be
“creative accounting free”. Though it sounds like a lot of bureaucracy, practice has proven it useful.

6. CONCLUSION

Our goal was to take a look at what has been written so far on the subject of creative accounting and to extract some solutions that would come as useful in the fight against creative accounting, which is in fact the fight for true and fair view principle. We considered both solutions related to accounting rules and professional accounting ethics; solutions that are to be put in practice by the company itself and by other interested parties. Without shrinking down the importance and use of true and fair view principle like other authors have done, we focused on the most practical solutions that would win us this fight.

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