THE FINANCIAL RELATIONSHIP BETWEEN ACCOUNTING REALITY, CREATIVE ACCOUNTING, AND OUTCOME MANAGEMENT

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Abstract

From the 17th century onwards, financial accounting initially followed the French model of Napoleon's commercial code, before turning towards the anglo-saxon model of the 19th century. Originating in the USA, the Anglo-saxon model evolved in the context of an economy led by groups of companies, to meet the needs of the capital market. As this market economy globalised, standardised accountancy procedures became a necessity for public expenditure, and the need for an international standards organisation became evident. Thus in 1973, the International Accounting Standards Committee (IASC) was founded in London. In 2001, this became the International Accounting Standards Board (IASB).

The principal objective of the IASB was the creation and publication of a set of global accountancy norms and standards, in the public interest, as a basis for transparent and comparable information in financial statements and other financial reports, which might give a solid grounding to the decisions of information users. All information presented in financial statements must reflect accounting reality in order to satisfy the needs of many different users, among whom there may be conflicts of interest. Conflicts of interest, together with loopholes in accountancy law, room for manoeuver in the creation of accountancy policies, and an accountant's freedom to choose his methods, can lead to managers massaging figures by exploiting so-called creative accounting *techniques. The practice of creative accounting for the manipulation of final profit figures is known as* outcome management*. These creative accountancy procedures may be restricted through international standardisation as well as through the IASB's initiative, which seeks to reduce the number of alternative interpretations and introduce more rigid standards and increased uniformity to accountancy procedures.*

Key words: *financial statements, accounting data, information users, accounting reality, creative accounting, outcome management.*

1. A study of the evolution of accounting legislation and standardisation

Financial accountancy in the civilised world began in Europe from the second half of the 17th century; the earliest known accounting system was launched in France in 1673, where the government introduced an annual audit, based on true market values, to protect the economy from collapse. This type of accountancy, a state initiative intended to control players of the system, was later incorporated into Napoleon's Commercial Code of 1807. It rapidly spread across the whole of Europe, thanks to the interests of the administrative bodies involved. Accountancy and financial legislation further developed in Germany after the unification of that country in 1870, when the emphasis shifted from market values to historical cost and systematic amortisation.

This accountancy model, in principle, regulated the relationship between private and state companies, through fiscal evaluation. At the same time, it limited dividend payments and protected the normal running of the economy, tightening down on private companies which were financially insecure or operating imprudently.

From the 19th century, as a consequence of the industrial revolution, a large concentrated capital investment was required for a number of industrial projects (initially canals and railways), the risk for which was to be shared amongst many investors. In this context, the financial report represented a method of monitoring the activities of component businesses, and keeping shareholders informed regarding the ongoing administration of their investment. Financial reporting for the needs of the capital market initially developed in the United Kingdom, where the state intervened and legislated little, leaving practices open to a great deal of interpretation. The USA rapidly followed suit as it industrialised. Since the USA had developed the notion of groups of companies controlled by a single head office, towards the end of the 19th century the philosophy behind their financial reporting systems similarly tended towards the consolidated accounts of conglomerates rather than of individual companies.

This Anglo-saxon accountancy model hinged on the relationship between businesses and investors and the flow of information from the capital market. Thus the government exploited accounting records as a method of regulating economic activity, in which the primary function of the state authority (the Commission for Transferable Securities) was that of protecting the investor and ensuring the efficient function of the securities market; thus financial reports tended to aim to serve the investor rather than the government.

Neither of the two approaches to accounting mentioned above, with their different objectives, were of any use in countries with agrarian economies or those founded on small businesses. Invariably, however, as such countries have developed economically, they have adopted one or other of the two models.

The second half of the 20th century has been characterised by major changes in accountancy regulations. In 1970, the Financial Accounting Standards Board (FASB) was founded in the United States of America, and the first national regulator was created in the United Kingdom. The European Union similarly achieved its key point in accountancy standardisation with Directive IV of 25 July 1978 regarding annual accounts for certain types of company. The United Nations (UN) and the Organization for Economic Cooperation and Development (OECD) also created accountancy committees.

In the context of the powerful tendency towards an international capital market and the appearance of diverse regional accountancy regulatory bodies, representatives of the Institute of Chartered Accountants in England and Wales (ICAEW), and the ***American Institute of Certified Public Accountants*** (AICPA), launched the idea of creating an international organisation to standardise accountancy, at the 1972 World Congress of Accountants. On the initiative of these two professional bodies, together with professional accountants representing Canada, Australia, Mexico, Japan, France, Germany, Holland and New Zealand, the International Accounting Standards Committee (IASC) came into being on 29 June 1973, in London.

Henry Benson, first president of the committee explained that the IASC had primarily come into being due to the *need for a common language in the face of ever-increasing international trade.*

According to its own documentation, the IASC's objectives were:

a) To create and publish, in the public interest, accountancy standards to serve as a basis for the presentation of financial statements, and to encourage

economic players, at an international level, to accept and respect these standards.

b) *To conduct business activities with a view to improving and harmonising legislation, accountancy standards, and procedures relating to the presentation of financial statements.*

In order to achieve these objectives, the IASC had by 2000 laid down 39 International Accountancy Standards and the Framework for the Preparation and Presentation of Financial Statements, while the Standing Interpretations Committee (SIC) had released 17 interpretations of the International Accountancy Standards.

The organisational structure of the IASC as an international watchdog was until 2000 based on professional bodies. From 1983, all professional accountancy organisations and all members of the International Federation of Accountants (IFAC) were members of the IASC; thus by 1 January 2000 there were 143 member associations in 104 countries, representing a total of over two million professional accountants.

The 1987 agreement between the IASC and the International Organization of Securities Commissions (IOSCO) aimed to create a set of core standards to serve as the minimum requirement imposed by all stock exchanges on overseas companies seeking a secondary evaluation. This led to:

a) *The revision and improvement of existing standards through the removal of the numerous alternative procedures hitherto permitted*

b) *The creation of new standards to plug existing loopholes including, among others, IAS 39 regarding the acknowledgement and evaluation of financial instruments*

c) *The reorganisation of the IASC's structure, in view of the fact that it was to become the recognised regulatory body of the world securities market*

In November 1999, the IASC's Work Group for Strategy presented its Council with "Recommendations for the future reorganisation of the IASC".

After the IASC Council's acceptance of these recommendations for reorganisation, IOSCO's adoption of IASC standards in May 2000, and the European Commission's announcement in June 2000 that it was to adopt IAS as a requirement for primary evaluation of all EU stock exchanges, IASC members voted in July of the same year to abandon the old structure based on professional bodies, and to adopt a new structure in which standards would be created by a professional council.

In April 2001 the International Accounting Standards Board (IASB) opened for business, its objectives being:

- To develop a single set of high quality universal accountancy standards in the public interest, which are understandable, applicable, and which impose high standards of quality upon information. This should in turn be transparent and comparable in all financial statements and reports, in order to support the economic decisions of participants in the world's capital markets, and other information users
- To promote the use and rigorous application of those standards
- To work proactively with national standards developers, in order to achieve the convergence of national accountancy standards with Internațional Standards of Financial Reporting, building high quality solutions.

The IASB meets its targets primarily through the creation and publication of the International Financial Reporting Standards (IFRS) and through the promotion of the role of these

standards in general financial statements as well as in other more extensive financial reports. They exist to support decision makers in their assessment of a comprehensive range of financial statements, with an end to reaching efficient and informed judgements.

International Financial Reporting Standards cover accountancy standards and the interpretation thereof, as approved by the IASB, and formalise the requirements of recognition, evaluation, presentation and description in connection with the important transactions and events characteristic of general financial statements. International Financial Reporting Standards are based on the *Framework* conceived by the former IASC, which tackled the fundamental concepts of information handled in general financial contexts, and consolidated a basis for professional judgements in the resolution of accountancy issues.

International Financial Reporting Standards are intended for general financial statements, as well as the financial reports of profit-making institutions in commerce, industry, financing etc., regardless of the organisational structure of the operation.

Between April 2001 and January 2005, the IASB revised 17 and withdrew three of the IASC's remaining Internaţional Accounting Standards. It also withdrew 19 of the 30 Interpretations of International Accountancy Standards (SIC), and IASB additionally issued six IFRSs and five Interpretations of the Financial Reporting Standards (IFRIC).

2005 thus marked the beginning of a new era in business, and the culmination of the IASC/IASB's efforts of over 30 years to create new regulations for financial reporting in the world's capital markets. Since 2005, over 15 000 companies across the stock exchanges of 25 European Union member states, Russia, Australia, South Africa and New Zealand have produced annual financial reports according to a unique set of rules – the International Financial Reporting Standards (IFRS).

2. Users of accounting information and their divergent interests

The principal line of communication between businesses and end users of accountancy data is that of information published in annual financial reports.

Annual financial reports are generated from information provided by accountancy, by way of which the activities of a given business are presented in a manner which enables users to take decisions of economic importance.

Ever since the tendency towards globalisation began to strengthen, and corporate interests began to dominate national economies, accounting systems have been obliged to serve diverse group interests.

As I have demonstrated in the preceding paragraph, a hierarchy of priorities has developed in the interests of meeting the information requirements of end users, as fast as accountancy itself has developed. Hence, in Anglo-saxon countries, investors represent the priority category of user, while in continental Europe accountancy serves a wide range of users in which creditors, and primarily the state, represent the leading categories.

This hierarchy of accountancy information users has brought about the need for harmonisation of practice and procedures through international norms adopted by the majority of countries.

The IASC's *Framework for the Preparation and Presentation of Financial Statements*, envisaged by the IASB, presents the following categories of user: current and potential investors,

employees, creditors, suppliers and other commercial creditors, clients, government and governmental institutions, and the general public. According to the position of these users relative to the business in question, they may be classed as *internal or external users. Internal users* are principally management personnel within the company. They have responsibility for information release systems, and therefore have access to supplimentary information. External users fall into the other categories mentioned in the Framework; according to their authority, they may be able to dictate the nature of the information to which they are privy, as is very much the case with governmental institutions (particularly the fiscal authorities) and banks, while others may be unable to have any say regarding the type of information to which they may obtain access, since they lack the necessary authority.

As far as decision making goes, different categories of user pursue differing objectives:

- C*urrent investors (shareholders)* principally follow the progress of their investments, future profitability, and the management's administration and direction of company resources towards their individual interests
- *Potential investors* follow the likely estimated risk of their future investments, profitability and stability of profits over time, and the long term capacity of the business to generate liquidity
- *Financial creditors (banks)* monitor the business' capacity to repay, and its degree of debt, solvency and liquidity, and the risk of being unable to recoup its borrowings.
- *Commercial creditors (suppliers)* monitor the financial security of their clients and the future development of business with these associates.
- *Clients* follow financial aspects relating to the long-term survival of the company, in order to secure continuity of commodity supply.
- *Employees*, through trade unions, are concerned with salary levels and job security, and are therefore preoccupied with the company's stability, performance and capacity to turn over large profits.
- *The tax office and other governmental institutions* solicit information in order to establish a basis for taxation, which represents state revenue, to permit subsidies in various public sectors, macroeconomic syntheses, market analysis, and the application of state economic policy.
- *The public*, through the administration of diverse communities, is concerned with the impact of the company's activities upon local economic development, the creation of new jobs, professional training, contributions to the local budget, and environmental impact.

The divergent interests of these users - clearly identifiable from the privileged status of certain categories among them (e.g. managers, fiscal authorities and banks) - derive from their position and power, and give rise to doubt regarding the objectivity of accountancy information provided by annual financial reports.

Conversely, specialist literature in the field refers to *agency theory*, which relates to the conflicts of interest between users of accountancy information.

An agency relationship comes into being when one party, known as the *principal*, entrusts management of their private assets to another party, known as the *agent*, who has competence and knowledge inaccessible to the principal. The most common form of agency is that in which a manager operates on behalf of a shareholder.

The conflict of interest between managers and shareholders, regarding data, is clear; since shareholders are principals who have empowered managers to operate on their behalf in the capacity of agents, the manager alone enjoys access to certain supplementary information.

Conflicts of interest surface where managers' remuneration is dependant upon profit and they may tend to push rashly for increased profits, or where they seek to maximise their own benefits at the shareholder's expense, through activity of which the business owner is unaware; perhaps in the form of loans to third parties in which the manager has a vested interest.

In other respects, the manner in which a business generates and releases accountancy data may be reduced to the goodwill and scruples of those concerned; internal users may take decisions on the basis of the differing interests of the various users of their accountancy data – managers may intervene in the application of accountancy methods and policies in pursuit of their own interests, thus compromising the quality of accountancy information.

3. Accounting reality, creative accounting, and outcome management

As has been mentioned earlier, accountancy is a tool serving to represent the operational activity of a company, and has at its core professional principles, norms and rationality. Ultimately, a company's financial reporting should consist in the assimilation and presentation of financial data in a way which should afford the end user a *faithful likeness* of the operation's activity, on the basis of *accounting reality*.

Accounting reality derives from a set of principles, evaluation points, rules, conventions and specific practices, and marks the central compromise between the interests of data producer, financial auditor, and end user of the data.

Regardless of the accuracy of this transposition of operational activity into accountancy information, it is nonetheless unavoidably susceptible to the manipulation of information which derives from the instinctive and human perversity of the business person and the conflicts of interest between the end users. Thus, financial reports tend to shift from the ideal to the desirable, from the point of view of those preparing them, such that the existing principles, rules and conventions of accountancy are expoited for personal benefit.

Specialist literature in the field has presented a series of case studies in which the manipulation of accountancy data has led to large scale financial scandals, such as the case of American energy provider Enron, which went bankrupt in 2001 following the exposure of irregularities.

The manipulation of accountancy data in the interests of providing a desirable operational image, as managers would like, does not necessarily imply a disregard for norms and regulations of accountancy procedure. On the contrary, this objective is often achieved without breaching the accepted standards, through the use of so-called *creative accounting*.

The expression 'creative accounting' is of Anglo-saxon origin and presupposes the use of legal accountancy practices which permit the company to present the desired public image.

Thus defined, creative accounting may be distinguished from accountancy fraud, in which data manipulation breaches accountancy rules. Creative accounting is in its turn however, also unacceptable, despite the fact that it respects the norms and rules of accountancy, since its ultimate purpose is that of distorting the perceived financial position and performance figures of a company, in order to mislead investors and other categories of end user of the accountancy information.

The creativity of accounting depends in principle, on the gaps in accountancy legislation, and the subjective judgements of professional accountants, which are made in the context of accountancy norms.

This last aspect is covered by IASB's Framework for the Preparation and Presentation of Financial Statements, according to which: *thus when the application of a norm detracts from the final outcome, this norm may be disregarded in order to achieve the closest possible reflection of real circumstances. The basis for such a decision being taken shall always be that of rational professionalism*.

The evolution of creative accounting makes assessment of a business' real position impossible, and seriously affects accounting reality through the manipulation of figures. Such practice is facilitated not only by the existence of loopholes in the rules, but also by the flexibility of the rules themselves, which permit a certain degree of methodological choice which may yet be exploited to transform financial statements in a manner favourable to management.

The most frequent creative accounting practices target profit figures in order to give an inflated impression of company performance. Such practices are referred to as *outcome management.*

According to specialist literature in the field, "outcome management" is the manipulation of accounts in order to create an inflated impression of company performance. The desire to reach or exceed the company's estimated average share price represents an incentive for outcome management.

Conditions which favour outcome management are diverse, but generally relate to a lack of internal controls or management experience, or complexity in transactions.

The most common outcome management techniques simply exploit the flexibility inherent in the framework of accountancy norms and regulations.

The primary outcome management techniques, which may be employed in order to fulfil the objectives in question are as follow:

- changes to repayment regimes
- changes to the useful life expectancy of frozen material assets with an end to depreciation
- changes to residual securities, with an end to depreciation
- establishing the likelihood of debt collection failure for irrecuperable monies or frozen debts
- identification of depreciated assets;
- estimates of probability regarding fulfilment of contracts
- estimates of commissions
- estabishing the demand on stock, and the depreciation thereof
- changes to the actuarial basis of pensions

Of all of these, the first three, which relate to changes relating to depreciation, may be considered discretionary in nature. These interventions in matters of depreciation may result from the modification of conditions affecting productivity, durability, or the state of the asset market in question, and represent an ongoing issue in the field of outcome management.

Extreme cases of outcome management involve false declarations, or the ommission of significant data from financial declarations. Such actions, intended to manipulate the end users of accountancy data, fall into the category of accounting irregularities or fraudulent financial reporting. In order to identify such procedures as fraud, one must prove that false declarations have been made for personal gain. Such actions indicate an abuse of profit figures which goes beyond the limits of the flexibility inherent in the norms and regulations of accountancy, and shows up above all in sales figures, outgoings, capitalisation of costs and the reduction of value in accountable assets.

The failure to acknowledge sales income, or the creation of fictional incomes, are among the most commonly encountered examples of misuse of outcome management. Examples of the aggressive application of outcome management strategies include the holding open of balance sheets in order to continue registering sales-related incomes which rightfully belong in later financial periods, or the entry of incomes connected to nonexistent sales.

Other examples of outcome management misuse include the underevaluation of company expenditure, capitalisation of costs, and the reduction in value of accountable assets whereby data is principally manipulated through:

a) capitalisation which fails to reflect true costs with interest

b) underevaluation of assets in order to reduce property tax

c) overevaluation of stocks

d) underevaluation of commercial and financial discounts.

The detection of outcome management scams is very difficult. Strategic discussions with the company management and auditors offer the greatest possibility of detecting the more blatent cases of corporate outcome management.

According to specialist literature in the field, outcome management detection techniques may be formalised as follows:

- *Employment of trend analysis,* which involves the comparison of quarterly profit margins and financial statements with those of the previous year, review of previous income and expenditure patterns, and the identification of significant changes in the last quarter
- *Probability-based examination of circumstances*, i.e. examination of unusual or rare transactions, verification of any unjustified changes in accountancy procedures, examination of any changes or adjustments made in the last quarter, changes in accountancy policies, a focus on areas open to professional judgement, verification of debt history, the age of stock holdings and outstanding payments
- *Analysis of annotations,* which implies reading those notes concerning accountancy policies and the evaluation of stocks, and comparing them with those of the year preceeding, examination of notes regarding pensions and other post-employment benefits in order to identify changes in policy
- Analysis of the correlation between predicted and actual profits, through examination of financial performance trends, checking of profits against average share price estimates
- Incentive analysis (motivating factors), which involves analysis of the climate in which the company is operating, with a view to identifying factors and motives which might inspire management to manipulate figures or disguise final profits.

Literature in the field of outcome management offers differing opinions on the issue. Certain authors feel that outcome management is detrimental to users, and investors in particular, since it

distorts financial performance figures, artificially boosts share prices, and encourages short-term decisions to the detriment of long term performance. Others hold the 'whitewashing' of figures, within reasonable limits and within the parameters of ***Generally Accepted Accounting Principles*** (GAAP), to be acceptable on the grounds that the resultant reduction in volatility brings a growth in benefits; the market perceives lower risks, and the share price tends towards stability. We argue the case for honest and transparent reporting of financial outcomes, regardless of the end user in receipt of this data.

It may be seen from the above presentation that changes in accounting methodology can lead to alternative perceptions of the financial position and performance of a business operation.

Room for manoeuver in the formulation of accountancy policies, and the freedom of accountants to choose their methods, have been the source of controversy in many papers covering the topic of accounting reality.

Aside from this room for manoeuver in the framework of generally accepted accounting practice, which permits producers of financial-accountancy information to manipulate profit figures and present a desirable image of their operations and performance, there is another issue. The existence of alternative accounting systems with differing agendas leads to large discrepancies in profit reporting, which companies may find themselves obliged to reconcile in order to conform to the rules of others' accounting systems.

Thus, in order to assert itself in international capital markets, a multinational company must align itself with multiple financial structures:

- one set of principles conforming to national regulations
- another set conforming to European accountancy norms, where the company is based in a non-EU country
- a third set corresponding to international accountancy norms
- an additional set corresponding to US – GAAP standards where the capital market is located in the USA.

In such a situation, the most important aspects of financial statements compiled by companies under national accountancy legislation must be reconciled with, and presented under, the other legislative frameworks in accordance with European, international, and US-GAAP accountancy norms. This has repercussions upon profit figures, the discrepancies among which must be reconciled. International financial communications must therefore overcome significant difficulties, hence the need for assimilation of all current accountancy methods into one coherent system, a process which may only be achieved through the standardisation and harmonisation of accountancy and its procedures at an international level.

We recognise that in order to limit the effects of creative accounting and outcome management, the IASB must reduce the number of permitted alternative methods available, in order to ensure a true harmonisation of systems whilst creating stricter standards to bring greater uniformity to global and international accountancy and financial reporting.

Besides the need for assimilation of all current accountancy methods into one coherent international system, and the resultant reduction in conflicts of interest between users due to the uniformity of public interest information, the conformity of these accountancy methods with the economic events that generated them can also be achieved by means of high standards in financial auditing.

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