True and Fair View: Incentive or Inhibitor for Creative Accounting?

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Abstract

The objective of accounting is to present information about the financial position, changes for the financial position and performance of an economic entity and the financial statements must present a true and fair view of the economic reality for the enterprise concerned. Creative accounting is a present issue, a phenomenon that increases users mistrust in financial statements, being considered a manipulation of figures in order to obtain a favorable image, far from being true. In order to address this issue, we analyzed several definitions and forms of this concept, and followed how they relate to the objective of the true and fair view. The paper points out that the interaction between creative accounting and true and fair view can be regarded in a double way: on one side, taking into account the influence of creative accounting on the objective of the true and fair view, and, on the other side, considering the influence of the perception of the true and fair view on the choice of these techniques.

Key words: creative accounting, big bath accounting, true and fair view, financial statements;
J.E.L. Classification: M41.

1. Introduction

The 21st century brings to light a new step for human civilization, a stage in which information, knowledge and communication are the key to social development, an era in which information represents power. But what happens when the information we rely on is altered, when someone manipulates us to make certain predetermined decisions? Known from the early 1970s, the expression „creative accounting" made sense in the UK at the time when these country had seen obscure business (Collase, 2009, p. 120) and it grew in size with the big corporate scandals. A phenomenon involving the use of the imagination of professionals in this field, sometimes risking to go beyond the limits of legality, creative accounting was noted many times and has been addressed in the accounting literature in a multitude of books and articles, by many authors, with different nationalities, debates that show the professionals' interest in this controversial concept.

In this paper we focus on the interaction between creative accounting and the ultimate goal of financial reporting, the true and fair view. We aim to explain the relationship between the two concepts, to show how the use of creative accounting techniques is influenced by the confusion and incongruity caused by the need to build a true and fair view of the financial statements.

The paper is divided in the following way: section two presents the methodological approach followed in the elaboration of the paper, the third section which presents the conceptual delimitations of the creative accounting and its forms, the fourth section presents a comment on the subject of true and fair view and ethical issues that conflict with creative accounting and the last part presents the conclusion.

2. Methodology

This paper introduces some definitions of creative accounting and true and fair view present in the accounting literature, the main components of creativity, starting from the Riahi-Belkaoui classification, the reasons why the professionals in this field choose these techniques and the problem of the true and fair view position in the struggle with the phenomenon of „creative accounting".

The methodological approach is inductive and refers to exclusively qualitative methods, the main ones being the documentation (analysis of the specialized literature) and the comparative analysis by appeal to a critical examination.

3. Reasons for creativity in accounting profession

Creativity in accounting is seen as a „misleading practice", a makeup applied to the true accounting situation (Cosenza, 2002, p. 64). It embraces practices in the gray area of the accounting profession (Collase, 2009, p. 121), practices contrary to ethics, found at the limit of legality, whose passage to illegality cannot be easily demonstrated.

In his work, Riahi-Belkaoui (2004) described creativity as a liberal interpretation of accounting rules and divided it, according to the objectives of those who prepare the financial statements. Thus, he proposes two major groups: *creative accounting* and *big bath accounting*. Creative accounting, in his view, is only a popular term in the press, that journalists have used to explain what they suspect that professional accountants do to make financial performance look better than reality (Riahi-Belkaoui, 2004, p. 57).

Defining the concept of „creative accounting" may seem, at first sight, an extremely simple thing. A present topic in the literature, an actual phenomenon that has been shaped mainly by large-scale scandals such as the Enron, Parmalat, or Andersen's consulting firm, does not have a single definition for all the aspects that compose it. Many authors have built definitions to explain this concept, being described either as *a process by which the management of an enterprise takes advantage of the shortcomings or uses the blurs in the accounting rules to present a modified image of the results*; (Shah, 1998, pp. 83–84) or as a *transformation of annual accounts using the accounting options, estimates or other practices accepted by accounting regulations* (Amat & Gowthorpe, 2004, p. 5). The most complete, comprehensive definition belongs to Kamal Naser who considers creative accounting:

1. the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practices, in order to transform financial statements from what they should be, to what managers want them to express;
2. the process by which transactions are structured, to produce the required accounting results rather than reporting transactions in a neutral and consistent way (Naser, 1993, p. 59).

Big bath accounting is considered, by most papers, a creative accounting technique that refers to the drastic reduction of profits in a period of time, to cause their growth in a future period (Riahi-Belkaoui, 2004, p. 58), being a fairly common practice, especially for newly elected managers who need to stand out. Using tools such as provisions, and the various depreciation adjustments, the managers could reduce the outcome either to distribute less to shareholders as dividends or to put themselves in favorable posture in a future period when the results will not be satisfactory. Ingenious in attracting investors, managers promise large dividends that include unrealized gains and sooner or later lead to the collapse of corporate giants. This practice proved to be very useful in times, when the distribution of fictitious dividends was in great demand. The normalization of accounting and the recognition of prudence reduced this distribution, but paved the way for new manipulations, which this time led to the creation of hidden reserves, accelerated depreciation and oversized or fictitious provisions, meant to diminish the distributable outcome at all costs. As a practice, „big bath accounting" has been dealt with in several specialized papers, and even more, in several speeches held over the years (Hirvonen *et al,* 2010; P. Lee, 2006; Walsh *et al*, 1991). IASB Chairman, Hans Hoogervorst expressed his dissatisfaction with the use of this practice, and has presented solutions to stop its use (Hoogervorst, 2015).

Cited in Riahi-Bealkoui (2004), Meehan stated that the use of this practice usually occurs during certain periods: when company managers are changed (new leadership is tempted to use this technique to demonstrate improvement in results in the years to come), when accountants register a nonconcurring gain, for which they are tempted to record large expenses to hide it, and there are times when earnings are weak and management finds it appropriate to add other expenses that normally fall for a future period (2004, p. 58).

In addition to Big Bath accounting, Breton and Stolowy also talk about three other techniques of creativity manipulation: earnings management that involves getting a desired level of business earnings, smoothing income that minimizes earnings variation and window dressing to get the desired financial reports (Breton & Stolowy, 2008, p. 6). The authors consider these techniques quite similar, notably earnings management, income smoothing and big bath accounting, which in one way or another target the manipulation of a company's profits. The dividing line between these three methods is very thin. Same authors consider income smoothing as a component part of earnings management, earnings management actually being, in the case of change of management, a case of big bath accounting.

Whether we are talking about manipulating earnings by increasing or minimizing them, smoothing them to eliminate fluctuations, or balancing financial statements, there is always a reason why managers choose this path. Among the most common reasons, raised by the accounting literature, we encounter: to benefit from certain tax benefits, to please the stakeholders, to maintain stable the price of shares, thus pacifying investors, and accessing loans, to position themselves favorably, in less favorable times. Regardless of the reasons given by the management of the entity, the use of these techniques should not be used under the auspices of the „purpose excuse the means" as they reduce the reliability of the accounting information. Aligning with Cosenza's conclusions (2002, p. 64), creative accounting is a kind of fraud every time it alters reality, a deceptive practice because it tends to induce users to make decisions based on false accounting information and can be understood as an intention to hide something, whenever no additional explanatory information is provided.

4. A short intake on the influence of true and fair view on the creative accounting

Although it has a long history in the evolution of the Anglo-Saxon accounting system (the first references to the concept being seen as a combination of the words „corect", „true", „honest" and „total" in UK regulations, in the Joint Stock Companies Act 1844), the true and fair view is still not clearly defined, both in the Anglo-Saxon and European accounting systems. It is interpreted as an imperfect translation of a philosophical concept of „common law" into a norm of „Roman-German law" (Honigman & Mondino, 2009, p. 39) and one of the few definitions given to the concept, published in 1981 in Lee's work, describes it as a „term of art". Lee asserts that the true and fair view requires the presentation of accounts, drawn up in accordance with General Accepted Accounting Principles, using as accurate figures as possible, reasonable estimates, thus arranging them so that the resulting image would be the most objective possible, without errors, omissions, distortions or manipulations. Both the letter and the spirit of the law must be taken into account (Lee, 1981, p. 270). In their work, Alexander and Archer assert that it is impossible to know, to predict exactly what information will be meaningful to users from one year to the next. It is therefore impossible to establish exactly what will be required to convey a fair view (1998, p. 207). The statement of the two authors can be considered a reason why this concept is not clearly defined. Not knowing the information necessary to users from one accounting period to another leads to the risk that no definition will be complete and include all the situations. Moreover, establishing a clear definition for the concept of true and fair view can transform it in a „rigid concept, not susceptible to future evolutions" (Toma, 2001).

One could say that the link between this concept and creative accounting is interesting and that there is more than one fair view, but, out of many others possible to be presented, a professional accountant can choose only the one that represents, in the most objective way, the economic reality of an entity. Using the options in the accounting regulations can lead to one fair view which, from the point of view of those who prepare the financial statements, is the correct and objective one. Following this assertion, Amat and Olivares have analyzed Lee's definition of true and fair view in order to determine if it is an incentive or an inhibitor of creative accounting (Amat *et al*, 1999, p. 9). So:

- The authors consider that the references to „the most reasonable estimates" and to „within the limits of current accounting practice" make the true and fair view an incentive for creative accounting. The existence of this tolerance can be considered the reason why, at the recommendation of the Institute of Chartered Accountants in England and Wales, the notion of

„true and correct view” has been changed to „true and fair view”, „correct” being considered to be a too powerful and precise attribute to reflect the practices of this profession.
We could say that Alexander and Archer's statement that you cannot know exactly what information will be meaningful to users from one year to another, so it is impossible to determine what will be necessary to convey a true and fair view, may also support the theory that this concept supports creative accounting. The fact that there is no constancy in the composition of the true and fair view only induces confusion and blurring, leaving room for interpretations that can help changing the image of the results.

- Lee talks about „an image as objective as possible, free from willful bias” i.e. neutrality, which is regulated, and implies that the financial statements do not influence decisions and judgments leading to a predetermined outcome. The fact that the information has to be presented in neutral form makes the true and fair view an obstacle to creative accounting.
- The references to „omissions” and „the spirit of the law” made some to consider the „true and fair view” more powerful, rigorous than the previous forms, „true” meaning the letter of the law, and „fair” its spirit. This interpretation makes the true image a tool against creative accounting.
- Lee also talks about „accounts prepared in accordance with the General Accepted Accounting Principles” and explains that if a court should decide whether a company's financial statements give a fair view or not, that would be the criterion by which the decision would be taken, making it difficult to identify other criteria. Given that it is a vague criterion, we can say that, from this perspective, the true and fair view is an incentive for creative accounting.

If so far we have determined to what extent the true and fair view influences creative accounting, consideration should also be given to the effect of creative accounting on the ultimate goal of financial reporting: the true and fair view. Article (9) of the Directive 2013/34 / EU specifies that „it is possible that, in exceptional cases, a financial statement does not give such a true and fair view where provisions of this Directive are applied. In such cases, the undertaking should depart from such provisions in order to give a true and fair view”, a statement that would allow us to understand that, under certain conditions, creative accounting can be considered a tool for obtaining a true and fair view (Pașcu, 2014, p. 136). It can be said that creative accounting has a dual role: positive and negative (Horomnea *et al*, 2012, p. 47), positive when helping to achieve the objective of true and fair view and negative when pursuing financial reports in favor of a small number of users, taking advantage of the flexibility allowed by accounting rules. There is a possibility that, when a professional accountant chooses a solution that better reflects reality, creative accounting being applied in this case knowingly and with good intentions, he could obtain more reliable results than in the case where he would have respected the strictness of legislative regulations.

5. Conclusions

Accounting practice around the world is abounding in negative examples. Whether it is about earnings management, income smoothing, big bath accounting or window dressing, creative accounting techniques are becoming more and more popular. Starting from the premise of „a thief passes for a gentleman when stealing has made him rich”, managers are trying their luck every time they turn to these techniques. Although creative accounting is still a legal form to circumvent the economic reality, from it to fraud it is just one step, and the users of accounting information are willing to drastically sanction these behaviors, which can sometimes make them lose. To use the true and fair view as an excuse for a better appliance of the accounting regulations makes its presence in this case not the happiest, and it is often in the situation to facilitate the use of such techniques. On one hand, the lack of a definition, a contradiction in building a fair view from one period to the next, and the references to the most realistic estimates cause confusion and at the same time pave the way for unfair techniques. On the other hand, it is recommended to deviate from accounting regulations if they are considered not to correctly reflect reality, thus encouraging creative accounting. In this case, we plead for a better understanding of the positive sides of the creativity, which can lead to a reliable, faithful representation of a company’s financial position and performance.

Like every aspect of this world, creative accounting has its yin and yang, a bright side and a dark side. Nonetheless, to believe that you can surprise its valences from one side, it is impossible. Thus, the negative side of creative accounting can only be removed by stopping the causes that led to its emergence, which takes time and it must be encouraged by people who are not willing to give up the benefits of these techniques.

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