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## **INFLUENCES ON, AND CONSEQUENCES OF ACCOUNTING POLICY CHOICES**

### ABSTRACT

*Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. The preparers of financial statements have an incentive and are in a position to manipulate the view of economic reality presented in those statements to serve their own pecuniary interests. In this principal-agent problem, the management files financial statements as an assessment of their own performance. Moreover, the management controls and decides upon the relevant information presented in these financial statements. Accounting regulation attempts to ensure that information is produced on a consistent basis in accordance with the rules that makes the financial statements more reliable for users. Nevertheless, the accounting regulation does not address the principal-agent and the moral-hazard problems. We propose a change of the practice in which the management is in control of their own accounting, controlling, and auditing mechanisms. Instead these should be passed to other bodies such as: stockholders and the boards of directors. However this has its disadvantages due to the lack of competences in accounting among these financial statement users.*

**Key words:** *accounting policies, aggressive and conservative accounting, accounting manipulation, financial statement misrepresentation, creative accounting*

**JEL classification:** *M41*

### **1. INTRODUCTION**

Financial statements provide information that is used by interested parties to assess the performance of managers and to make economic decisions. The users of financial statements may assume that the financial information they receive is reliable and fit for its purpose. But, in reality, the preparers of financial statements have an incentive to misrepresent those statements as their own performance is assessed by the same financial information they are providing. It is a clear principal-agent problem. Accounting regulation attempts to ensure that information is produced on a consistent basis in accordance with the rules that make it more reliable for users. But it does not address the principal-agent and the moral-hazard issues. There are many causes and

many forms of accounting manipulations done at management level, and influenced by the accounting policy choices. The International Accounting Standard (IAS) 8 – Accounting Policies, Changes in Accounting Estimates and Errors, deals specifically with accounting policy changes. There are many sources of accounting policy changes, and inequalities between enterprises and countries.

## **2. THE SOURCES OF ACCOUNTING POLICY INEQUALITIES**

All changes in accounting policy that are not endeavoured for the purpose of making financial statements more relevant and reliable might be undertaken for the purpose of accounting manipulation. Manipulation is commonly defined as "any intentional act or omission designed to deceive others, that results in losses to third persons i.e. the victims of manipulation".<sup>1</sup> Accounting manipulation includes two basic types of manipulation; it is an "adjustment" of financial statements. Regarding the affected parties, it comprises:

- manipulation of the state in favour of the company, shareholders, management, and/ or
- manipulation of the company and its shareholders, in favour of the management.

Although the companies have developed elaborate systems of controlling, which help to ensure accurate, precise and prompt monitoring of accounting procedures and proper application of accounting standards, such systems only help to prevent random errors in accounting. They are not supposed to prevent or detect management accounting shenanigans. The management has a special role and is in the position of controlling the information and its pursuant use by the established company control mechanisms. The management is an agent on behalf of the stockholders (the principal), but the informational asymmetries are strongly skewed in favour of the management.

Individuals that deliberately and consciously manipulate financial statements in an attempt to circumvent accounting procedures and at the same time cover up their actions are very difficult to discover by controlling. Controlling can only check for information that is already there. Lack of evidence makes it difficult to individual's financial statements very difficult to prevent, detect and stop.

The manipulation of financial reports is especially present during economic booms as some companies cannot keep an accounting track of their growth and in times of slumps as they "clean" financial statements of positions burdened in times of excessive growth. Accounting manipulations are especially present in companies where management bonuses directly depend on operations' results. An increase in accounting manipulation started with the liberalization of accounting principles and policies, and especially upon the introduction of the third tier of fair value accounting. Especially problematic is the introduction of the third tier of fair valuation: the recognition of fair value without any externally visible indicators. It is an internal valuation exclusively

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<sup>1</sup> The Association of Certified Fraud Examiners, The American Institute of Certified Public Accountants, and The Institute of Internal Auditors: *Managing the Business Risk of Fraud: A Practical Guide – Exposure Draft*, November 12, 2007.

dependent on internal “forecasts”, present value calculations of forecasted cash flows and similar. The occurrence of these indicators and the use of third tier fair valuations do not necessarily prove manipulation, but they provide adequate signs of warning for possible fraudulent behaviour.

We concentrate only on the ones at enterprise or micro level, even though there are also manipulations done at macro-level. The term 'macro-manipulation' is used to describe the lobbying to persuade regulators to pass regulation that is more favourable for financial statement preparers. These manipulations will not be analysed in this paper.

"Micro-manipulation", or accounting manipulation done at entrepreneurial level describes a biased presentation of accounting figures at entity level for the purpose of deceiving their most common and direct users, not including the management. This type of informational asymmetries is often referred to as "creative accounting" or "earnings management". These manipulations may be regarded as morally reprehensible; i.e. not fair to the users of financial information. They involve an unjust exercise of power, and they tend to weaken the authority of accounting regulators. The communication between entities and shareholders may deliberately be distorted by the activities of financial statement preparers who wish to alter the content being transmitted.

### **3. THE ROLE OF ACCOUNTING REGULATION**

In most countries accounting is regulated by means of: a) local laws and bylaws relating to corporate and other bodies, and b) a system of accounting regulation in form of standards.

Accounting standards are often promulgated by non-governmental, professional organisations and foundations. Moreover, in recent years, a supra-national body, the International Accounting Standards Board (IASB) has become more important in setting those standards. The Board is heavily pressured by political lobbies from EU and USA. These pressures are mostly related to some accounting scandals and economic crises and recessions.

Fearnley and Macve (2001) identify some of the principal weaknesses prevalent in national systems of compliance: weak support mechanisms for auditors, lack of effective sanctions against directors, and differences between the legal framework and practice.<sup>2</sup> Cairns (2001), summarising the findings of his International Accounting Standards Survey published in 2000, notes a substantial level of non-compliance with international standards amongst companies claiming to have adopted them. It is important to note, that a company endorses the IFRSs if, and only if, all financial statements are disclosed and presented in full accordance with the IFRSs.

An important factor in accounting regulation is the sheer scale of the economic impact of the accounting rules. The choice of an accounting rule may have a very significant

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<sup>2</sup> Fearnley, S. and Macve, R., *Global Problems*, in: *Accountancy*, nr. 128, 2001.

impact on, for example, reported profits. The level of profitability of a commercial entity potentially affects the distributions to owners, wage and salary negotiations, level of pension funding, ability to borrow or raise further risk capital, taxes paid and the like. The stakes are high, especially in the context of major national or multi-national corporations whose activities have consequential effects on the lives of many people.<sup>3</sup>

There are two principal means by which the intentions of the regulators can be confounded by preparers. Firstly, preparers may lobby against proposals for rules that will have an adverse effect upon the financial statements. Secondly, when strict application of the rules does not produce an accounting result meeting the needs of preparers, they are motivated to misapply or to ignore the rule. This condition can pertain only where regulation is weak and/or is inadequately enforced.

#### **4. THE ROLE OF ACCOUNTING POLICY CHOICES**

According to the IAS 8, accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Accounting policy choice is a necessary extension of the accounting regulation in form of laws, bylaws and standards. Accounting policies are necessary for providing more reliable and relevant information in financial statements on the effects of transactions, other events or conditions on the entity's financial position. This information has to be presented in an undistorted and consistent manner. Legal distortions in the presentation of financial information, presented as accounting policy changes that favour some indicators of managerial compensation, may guide the users of financial information to make wrong economic choices regarding their investments.

The following table shows how the accounting policy choices influence the financial position items in view of the three most important agents (the government, the management, and the stockholders) and vice-versa.

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<sup>3</sup> Zeff, Stephen A., The Rise of Economic Consequences, in: The Journal of Accountancy, December 1978, available on: <http://business.illinois.edu/doogar/accy493/zeff%201978%20joa.59> (April 20<sup>th</sup> 2011).

**Table 1: The accounting policy matrix of financial position elements and agents**

	<b>Government</b>	<b>Management</b>	<b>Stockholders</b>
<b>Long-term illiquid assets</b>	Revaluation, Valuation base, Valuation method	Fair value (if tax deferral allowed) Amortised cost, “ease of use”	Fair value “informational value”
<b>Inventories</b>	FIFO, LIFO, ... Weighted average, inflation impact	LIFO (if allowed), weighted average	LIFO (if allowed), weighted average
<b>Accounts receivable and liabilities</b>	Influence of taxation (VAT, Income tax...)	Do not recognise revenue until 100% receivable	Adjusted income
<b>Money</b>	Taxes	Working capital	Retained earnings, dividends

Source: Author’s own representation.

Besides the above enumerated accounting policy uses, there is a myriad of possible revenue and expenses manipulations using accruals and deferrals i.e. too early or too late recognition of revenues and expenses, which is a favourite creative accounting tool.

The goal of these strategies is to increase the company value in order to increase the wealth of managers through various company incentives such as bonuses or company stock options or to shift the profits to a later period, when these incentives may be materialised. Similarly, the company profits may be hidden for the purposes of tax avoidance and/or creating hidden reserves.

## **5. POLICY CHOICES ON A MACRO LEVEL**

On a macro level, regarding the various sovereign accounting systems, policy choices may influence the overall level of accounting conservatism. Accounting conservatism and its pursuant index of conservatism is the measure of differences in reported earnings of equal business outcomes under different accounting environments. The country’s accounting aggressiveness or conservativeness depends on legislation, tax, codes, professional accounting financial system but also culture. It is possible that different countries with similar accounting laws and equal accounting standards but different financial systems and entrepreneurial cultures result in different levels of accounting conservatism. So for example, a company registered in the UK may report under equal business outcomes greater revenues, even up to 50% than a similar Germany based counterpart. The two companies may have equivalent company laws based on Common Market principles, same International accounting standards (IFRSs), but differences in financial systems and structures, company and management cultures. A financial system based on venture/equity capital and a strong investment funds/shareholder based culture, together with profit rewards compensated

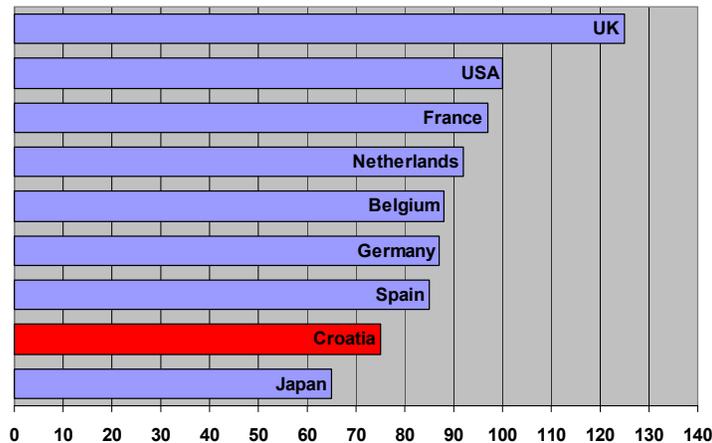
management is a system that tries to increase short term shareholder value. It is a system that increases short term profits, regardless of the long-term sustainability.

A financial system based on debt/banking capital and a weak shareholder base, seeks to increase company welfare within. Debt capital is leverage capital and it does not pursue shareholder value interests.

An accounting conservatism index, (Unites States set at 100), has been constructed for Croatia. The index is based on the comparison of 25 CROBEX companies listed on Zagreb Stock Exchange and their Financial statements (carefully following the notes to the financial statements!) pursuant to form 20-F of the US Securities and Exchange Commission (SEC) and according to US-GAAPs serving as a benchmark of what their financial statements “would – look – like” if they had been listed on the New York Stock Exchange.

The calculation of the Croatian conservatism index has several significant drawbacks. Firstly, there are no Croatian companies’ stocks listed simultaneously on Croatian and foreign exchanges. The conservatism index cannot simply be translated from the same companies’ income statements. The conservatism index methodology tries to compare the possible outlook of the income statements of a company under different sovereignties’ legal and accounting systems. For companies that are not simultaneously listed on a domestic market and a stock market in which a conservatism index already exists, a lot of accounting policies are to be imputed, i.e. the best accounting policy alternative would be for a company in a particular sovereignty. It is a major methodological drawback, because we cannot know for certain what and why a company’s “real” choice would have been. Secondly, the index is, beside the above mentioned reasons of differences in accounting profits, also heavily biased by sector company issues. Croatian companies have a different business structure and are found in different business sectors. Croatian companies are more “traditional“. The Croatian companies that could compare well are all subsidiaries of foreign companies and present their consolidated financial statements according to their “parent’s” accounting policies. In some circumstances, where the two policies are different, and of course if they can be found, this becomes an important comparative tool. A conservatism index comparative table is shown below.

**Figure 1: Indices of conservatism for selected countries**



Source: Radebaugh, Gray, Black, International Accounting and International Enterprises, Wiley & Sons, 6th ed., 2006, p. 109. Authors own additions.

The US and UK conservatism indices are upwardly biased by the new ITC companies. These are companies without any significant tangible assets, with significant internally created intangible assets, high liquidity, high return on assets (ROA) and equity (ROE), liberal employment and accounting policy environments. Subsequently, the companies are short-term-profit oriented, with low reserves, and highly flexible investments.

The continental European (German, French, Italian and Spanish) conservatism indices are downwardly biased by: conservative accounting policies promoting redundancy, reserves, and caution; are influenced by rigid employment markets, high share of tangible assets (sunk costs), and a high share of long term highly collateralised debt.

There are also some offsetting issues. For example, the US tax rate is a very high 40% with subsequent double income taxation at a personal level, should theoretically have a strong downward conservatism bias, whereas all European jurisdictions have decreased their corporate income tax rates, but nevertheless maintained their high overall tax burdens. We see no significant corporate income tax impact on the conservatism index, but, we see some overall tax burden impact on the conservatism index.

## **6. CONCLUSION**

The preparers of financial statements have an incentive and are in a position to manipulate the view of economic reality disclosed in those statements to serve their own pecuniary interests. In this principal-agent problem, the management files financial statements as a proof of their own good performance, whereby it controls and decides upon the relevant information presented in those financial statements.

Accounting regulation attempts to ensure that information is produced on a consistent basis in accordance with the rules that makes it more reliable for users. But it does not address the principal-agent and the moral-hazard issues.

Nevertheless, the management still has a lot of maneuvering space as it controls and applies the accounting policies. The role of the government and the standard –setters is here minimised as it can only marginally control the accounting policies. Accounting policies are managements' last legal resort of creative accounting, and are widely used for the purpose of “fixing” financial statements.

The principals cannot still avoid being manipulated. The informational asymmetries in favour of the management may only be tangled by a more powerful and informed board of directors and, at the end, the shareholders having a minimum competence in accounting. Nevertheless, information that has never been entered into the accounting system remains inexistent and may never be detected as missing. It is necessary to control all input, process, and output information, in its financial and physical form, at all levels of the entrepreneurial practice.

A change in the present praxis of the management being in control of its own accounting, controlling, and auditing mechanisms, and instead passing those to other bodies such as: stockholders and the board of directors may be a viable solution. Lastly, we propose that the board of directors on behalf of its shareholders be the only comptroller of an independent audit.

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