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# Valuation of Authentic or “Misleading” Accounting Information in Preparation of Economic Decisions



## *Summary*

In summary, regarding the valuation of authentic or “misleading” accounting information in preparation of economic decisions, we can say that management accounting provides financial and non-financial information to management to have an effective decision making system. However, accounting indicators were developed for monitoring and reporting purposes, and even today these are the main area of use. The standards applied by international systems increasingly try to follow and help to improve the content of information of investors and management therefore; they do not have a primary role in this, so this kind of functionality of management accounting will not be reached.

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The global economy and our modern society is characterized by complexity and networking. In these complex network-based relationships, trust in information plays an important role. However, in the development of economy and society, financial institutions, intermediaries, insurance companies and the stock market attract more attention. Entering the stock market – in addition to the existence of collateral – it is well known that transparent accounting and reporting, financial reporting is required. There is evidence that the market will only work if the information is authentic and

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market operators and investors can effectively and objectively utilize it. In the early 2000s, especially events and the known scandals of the capital market of the United States – such as the Enron, WorldCom and Arthur Andersen – had raised the question whether corporate financial-accounting traditional standardized order is in a crisis.<sup>1</sup> Increasing market price of shares had become a primary objective for companies in order to ensure the satisfaction of investors. Market prices increase due to good economic news, then financial reports, evaluation indicators appear and trust toward the companies' securities grow until fraud. The completeness, credibility and reliability are principles that serve as a basis for not only the operation of stock market but also in the creation of market relations of economic actors. After the scandals auditors were rightly accused, and faith in accounting had shaken, it is inconceivable that “economic scandals” developed due to ethical failings of auditors, accountants. Managers, auditors, security analysts, consultants, investment and commercial banks, lawyers had also contributed to false informing and manipulation.

Due to recent developments in the economic situation, accounting contrary to the intended function – namely it provides authentic information through financial reports about the financial status, profit-making ability of companies, disclosing all the data which could influence the decisions of investors – had become a tool for managers' to reach their operative goals and mislead investors. We can say that companies have been looking for accounting solutions which “generate value” in line with market expectations, so for a short time, they could preserve the illusion of growth.<sup>2</sup>

The history of the development of distorting economic information has several connection points with management support of accounting and financial information. This is confirmed by economic history situations as well, in which several questions have arisen in relation to the financial reporting system that allows the assessment of the company. For the concept of a free market the ability of correct valuation of a company, reliability of financial statements and realistic presentation for market participants are essential.

It is natural that these large accounting scandals had questioned a number of adopted and in use practices. Note that this has not always been like this, mainly after the 1920 crisis the accounting industry started to look for the options to restore consistency, transparency and confidence. In the early 80s, globalization and deregulation has brought new challenges to the business environment which demanded large amounts of money and resulted more complex and risky financing instruments were introduced.

Pay system of company executives were linked to performance whereupon they were directly motivated. Preparation of economic information, the accounting and financial solutions which distort real processes namely the non-objective view to the economic background. Several cases prove that the priority goals of managers were to have good financial stability indicators for the company in addition to the various transnational issues.

Improving liquidity, rates of return, improve profitability ratios, etc., and of course, all this happened in order to maintain share prices, affecting the external percep-

tion with these distorted economic information.<sup>3</sup> It can be observed that in order to achieve their goals, “slick” creative accounting solutions were widely used among the companies, to mention a few:

- Failure to consolidate business units and subsidiaries (which made it possible to hide investment losses and problem loans, the sale of idle assets to subsidiaries).
- Transactions with no economic content – creating fictitious revenues within which the swaps are not accounted for in the same way.
- Accounting doubtful accounts receivable as current income.
- Accounting sales of assets as operating income.
- Accounting manipulations related to merger in order to increase sales revenue/profit.
- Lease-related accounting manipulations.
- Accounting future cash flows as today’s revenue, lending or leasing.
- Wrong application of value adjustments.

After the economic financial and accounting scandal a wide-ranging analysis began to detect the causes. At the same time of economic and social effects; the efficiency, self-regulating capability, credibility and ethics of the entire accounting profession/system is questioned. Several studies had focused on integrity, a “back to basics” idea, which reminds the time when accountancy profession was called “Gentlemen’s Profession”. The moral error was clear, but not just for accountants, but also for managers, bank analysts. Boatright<sup>4</sup> in search of the origins of financial fraud claims that they do not start with dishonesty. The effectiveness and proper functioning of the corporate governance system were also analysed. Agrawal and Chadha studied with empirical methods, whether corporate governance mechanisms are in connection with the likelihood of the subsequent correction of the financial statements of a company.<sup>5</sup> It is important for the participants’ individual moral consciousness and financial culture of a given economy has a decisive role.

The role of cultural differences in the economy operation of countries’ real processes and competitiveness has been repeatedly analysed. Social and cultural context of the impact of financial processes can be clearly demonstrated in which trust, integrity, ethics and moral background plays an important role.<sup>6</sup> However, the importance of financial markets has grown in the last five-ten years, which has drawn attention to the systematic assessment of the global need for financial literacy. Recognizing the level of financial literacy affect financial stability of the economy and trust market participants.

Several central banks of developed countries – in Hungary it is the Central Bank of Hungary – play an active role in improving financial literacy of the population, the development of the financial culture. When these economic and financial issues mentioned above are global – such as the geopolitical effects – global capital flows can be negatively affected. Consequently, attempts to overcome and solve operational difficulties exceed the limits.<sup>7</sup> Behind them, almost always there is the pressure for short term results (financial accounting pressure, achieve higher share price, meet investors’ expectations etc.).

For this reason, it is important to highlight another, sometimes incomplete and confusing areas of accounting regulation. It is well known that economic effects determine financial behaviour eg. influence making purchases, paying bills, saving etc. Consequently, the behaviour is an essential component of financial culture, one of the most important parts.

A person with good financial education – active member of the society as well – always have an idea about how much he can spend on a service or a product. In order to have an advanced financial culture, active organizational skills are needed so that individuals are able to their financial obligations and avoid financial problems.<sup>8</sup> In my opinion, in the development and standardization of accounting systems, high executive compensation incentives linked to financial performance played an important role. Institutional investors encouraged this trend, as it seemed to be contributing to good corporate governance, thus the interest of shareholders and managers harmonize. Market deregulation which initiated the development of new business models in the energy industry and in telecommunications, which required accounting methods tested by GAAP.<sup>9</sup>

However, banks involved in international investments developed complex financial instruments, which allowed for instance to account loans as trade.

This deregulation, which had the aim of making the business more efficient, had unexpected consequences of weakening constraints of companies and investment banks providing accounting services

In my opinion, Denis clearly highlights the factors which refer to the high risk of company operation and financial statements.<sup>10</sup>

Some of these:

1. Link manager compensations to bonuses, stock options and other incentives.
2. Management is dominated by a single person or small group, and is not limited by the board of directors or audit committee.
3. Management defines unlimited aggressive goals related to the operational functioning of the company.
4. Management ignores regulatory-control requirements of authorities.
5. Management acts dominantly against the auditors.
6. The company carries out unusual and complex transactions at the end of the year.

It can be stated that everyone – advisors, accountants, auditors, lawyers, bankers, analysts, managers – is responsible for providing real information.

Board of directors, the management, accountants, and market analysts have common interest and responsibility to inform investors and creditors about past processes and future perspectives of the company.

However, it can be said that leaders who are committed to serve the interest of shareholders – manipulated earnings, hid debts and falsified accounting data – to enforce their stock options, on shareholders expense, auditors allowed “aggressive accounting” and certified financial statements, which turned out to be false.

Requirements of the accounting information system:

Examining the contents of the accounting information, I agree with those scientists who came to the conclusion<sup>11</sup> that the objectivity of information ensures the credibility, neutrality and clarity of information.

These can be summarized in the following five points:

- Proof of accounting information means that all accounting information based on a receipt.
- Credibility means that information is reviewed by an independent person and objective.
- The most important quality attribute is relevance. Accounting information is essential when it assists to decision making and implementation of plans.<sup>12</sup>
- Clarity means that accounting information needs to be understandable, clear and concise. According to Mrs. dr. Tangl excessive compression leads to less effective use of information.<sup>13</sup>

Several approach considers that “accounting information needs to be up to date that is to be available after the accounting period” as an advantage. In my opinion timeliness of management supporting information is necessary, because late submitted accounting information lose its importance. It is important to mention that submitting accounting information in time leads to the increase in the cost of acquiring them. Several researchers have modeled and associated the costs of additional information with the benefits of it. Assumed it can determine a point after which the cost of additional information is greater than the benefits.

Users compare accounting information of different companies, thus it is necessary to measure and evaluate economic events the same way. The main purpose of the compilation of accounting policy is to provide a true and fair view of the financial performance, assets and income of a company. The value-oriented presentation of the company’s activity has to be in line with the administrative accounting and must be built into its functionality.

However, without the comparability of information, the administrative accounting value creation (accounting administration value) cannot be achieved which is required by the shareholder and investor attitudes more and more.<sup>14</sup>

Accounting records what happened and what is happening in the company, in relation to its environment and within the company as well. The condition of the fulfilment is determining users how and from what they receive information from.

Based on this, it is possible to determine what information accounting needs to provide. In some organizational form when owners have the leadership of the company, they can contribute to all accounting information, which they need for their decisions. If the owner of the company is separated from the direct management, owners do not have access to accounting information. This information is received indirectly in the form of financial statements, reports according to which management make such decisions that requires more information than other users.

Studying leader controls, it is revealed that feedback function of accounting is about providing information whether the company has reached the planned leadership goals. In case of a difference, management makes a decision about the necessary

actions similarly as the analytical functions of business and management economics. The implementation of the reporting function can be displayed with continuous monitoring of the decision and accounting provides information when decision is implemented. This information informs about the invested assets in the economic activity and their changes. When developing an accounting information system, characteristics and information needs have to be taken into account, because business processes can only be followed properly.

It can be seen that accounting indicators were developed for reporting and monitoring purposes and even nowadays these are the main area of use therefore primarily they do not have decision support roles. Accounting indicators provide a lot of information about the past, besides they are used as a criterion for decision making plans with different time horizons. Estimating multiplier numbers, sales revenue, book value or earnings before interest and taxes can be used as a base for the evaluation. Accounting measurement indicators include earnings per share, Price/earnings ratio and different rates of return.

In fact, if we accept the condition that performance of companies do not match with their economic performance, than information provided by them may not be as useful for managerial decisions. It is noted that investors do not judge on the basis of accounting profit but the return on the companies' investments. In case of listed companies, return is based on the change in share price and combined value of dividends; on the other hand (which can be calculated in various ways) in private companies, market value and loans give the fair value of owners investments and this is compared to the original value of the investment.

The decisions of investors are influenced by risk, future performance of the company. Investors are thinking long term, making up accounting results do not increase but decrease the trust of investors. Many authors such as Stern Stewart & Co. (2000) – found more than 120 distortions in the US-GAAP system – mention distorting factors of accounting systems and lack of derived indicators. Keith and Madura believe that the most serious problem is that accounting is past oriented not the support of decisions; information in general is aggregated with incorrect structures, not suitable to analyse factors influencing the results. In addition, it indicates the overweight of financial indicators and the need for non-financial information. Accounting distortions cause major problems in three areas of value-based theory – inventory valuation, depreciation and activation of capital costs.<sup>15</sup>

So we can say that accounting indicators can be bad advisers in decision situations. Due to these, the motivation of management can mislead, since “development” is based on accounting categories. Mayer already pointed out the importance of the real content of accounting information that is the biggest disadvantage of accounting reports is the focus on “accounting costs” which encourages management to minimize these numbers.<sup>16</sup>

Several authors characterize the concept of financial accounting as periodic reports, transactions of activities of a company or other economic entity. Reports, that have either general or specific targets, provide information to managers, owners,

creditors, institutions and to the public. According to Zéman accounting is an information system about the economic events of the company so that market participants can get a true and fair picture of the company. In my opinion, financial accounting shows the continuous record of economic events from which the following conclusions can be drawn:

- Financial accounting is the record of economic events in monetary units and compilation of statements that are prepared to meet the information needs of external users, determining the economic results of the company.

- The content of financial accounting as a modern concept can be interpreted broadly. Many researchers think that several information requirements can be classified here such as the ability of company management to rationally finance the activity of the company and the choice of the optimal financing form, optimal composition of resources.

Traditional accounting systems do not deal with the effects of added economic values, unable to evaluate the company's environmental assets, taking into account the interests of current society and future generations regarding the effects of corporate activity on environment.<sup>17</sup> According to Pál the existence of externalities is ignored and only financial categories and impacts are taken into account.<sup>18</sup> According to Zéman management accounting provides information about the past and estimated data of the future for corporate governance activities and strategic planning thus it provides information that are needed by the managers to make decisions and monitor business processes.<sup>19</sup>

In Anglo-Saxon countries the content of management accounting is wider regarding cost accounting and data of financial accounting. Leslie Chadwick and Pauline Weetnei believe that management accounting can be summarized in 10 points:

- Cost accounting, which aims to measure the performance of departments, products and services.

- Provide information to management which aims to ensure proper flow of information for managers (reports, statements, tables etc.) as and when it is required. A regular flow of information allows management to respond as soon as to any problems that may arise.

- Management consulting – give advice to management in connection with decisions and economic consequences and implementation of alternative actions.

- Forecasting, planning and control. Management accounting links to future and pre-determined systems such as audit plan and other cost accounting methods. These methods examine the differences which are resulting from the difference of actual and projected performances.

- Communication. In order to have an effective management accounting system it is essential that a reliable and efficient communication system is associated with it.

- Systems. The management accounting department should be actively involved in cost control and design of financial reporting systems.

- Flexibility. Management accounting must be flexible in order to respond quickly to any changes that may occur.

– Taking into account other business tasks. Information providers should be aware of the roles of other business functions as well. They should ensure cooperation and coordination with other functions too.

– Training of employees. Management accounting department must provide the necessary information.

– “Guarding gate”. Management accounting is in a kind of position of authority what provides the “requiring access” (can receive and send information) to management, maintains relations and receives information from the external environment.

Consequently, it includes all methods and procedures that help management decision making. In my opinion, we need to find a common information set, which help management accounting in decision making and establish accounting policy based on those. In summary, regarding the valuation of authentic or “misleading” accounting information in preparation of economic decisions, we can say that management accounting provides financial and non-financial information to management to have an effective decision making system. However, accounting indicators were developed for monitoring and reporting purposes, and even today these are the main area of use. The standards applied by international systems increasingly try to follow and help to improve the content of information of investors and management therefore; they do not have a primary role in this, so this kind of functionality of management accounting will not be reached.

## NOTES

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