The Misrepresentation of True and Fair View in Accounting

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Abstract: *The highest objective of accounting in a market economy is to give a true and fair view of the business's economic reality. The true and fair view is the result of the correct application of generally accepted accounting principles and established accounting procedures, which is inextricably linked to the application of ethical principles in activities of accountant experts. By applying generally accepted accounting principles in the accounting policy of the accounting entity, it is possible to achieve as true and fair view of the accounting entity's economic reality as it is possible to obscure and embellish the entity's unfavourable situation or intentionally aggravate the entity's situation by a suitable application of accounting principles. This paper clarifies the motives for misrepresentation of information in financial statements, as it approximates the techniques of misrepresenting information in financial statements and presents detection methods of material incorrectness in financial statements.*

Keywords: *true and fair view, misrepresentation, financial statements, creative accounting, detection methods*

JEL codes: M40, M41

1 Introduction

The true and fair view principle is considered to be the highest principle, all other accounting principles are subordinate to it. It takes on the importance of the superior criterion because it is of paramount importance for the decision-making of current and potential owners, investors, creditors and other users. The true and fair view principle is respected by all forms of international harmonisation and by the accounting legislation of individual countries (Egan and Xu, 2020). The true and fair view principle is interpreted in such a way that financial statements must be prepared in accordance with applicable accounting legislation or accounting standards. However, this does not mean that accounting must provide „only one correct view" of the entity. Accounting captures phenomena that takes place in a quite dynamically developing market environment and therefore, from the information function of accounting's point of view, a true and fair representation of the facts must be assessed in terms of the relevance of accounting information to the needs of their users (Hunyady and Domaracká, 2015). The interpretation of many phenomena is often ambiguous, experts estimate quantities, generally accepted accounting principles allow alternatives in several areas (Smieliauskas, 2012). Both accounting legislation and accounting standards offer a number of permissible solutions that bring a significant dose of subjectivity to these areas, even when financial statements are prepared in an effort to provide a true and fair view. As a result, an entity may quantify and recognise its profit or loss within the permissible rules in a very wide range, each of which is correct when it falls within a given range (Makrani and Matoufi, 2019). Information in financial statements is often misrepresented because of its importance to users' decision-making and ability to influence their judgment.

The purpose of this paper is to clarify the motives for the misrepresentation of information in financial statements, to approximate the techniques for the misrepresentation of information in financial statements and to present detection methods of material incorrectness in financial statements.

This paper's importance lies in the solution of the current topic such as the quality of the information provided in the financial statements. This paper emphasizes the importance of the true and fair view principle, while it points to the manner in which it is achieved in financial statements and to the possibilities as well as levels of its misrepresentation in financial statements. This paper also explains the motives and techniques of true and fair view misrepresentation because only by knowing it, it is possible to improve detection methods and thus contribute to the restoration of trust when it comes to financial reporting.

2 Methodology and Data

Such aspects of true and fair view misrepresentation as the motivation, techniques and detection methods of misrepresentation are the object of exploration in this submitted paper. The true and fair view principle is regarded as a fundamental principle of double-entry accounting, which ensures the objective of accounting in a market economy, namely to give a true and fair view of a financial position, performance and changes in a financial position. In this paper, misrepresentation means a wide range of adjustments of information disclosed in financial statements. From those resulting from alternatives offered by accounting regulation and which merely cosmetically adjust a „true and fair view" in the desired direction, to those adjustments which represent a gross manipulation of the entity's information and are signs of fraud.

This paper presents and analyses the above issues as they are currently treated under current legislation. We found inspiration in preparing this paper in book publications, articles in professional journals, proceedings papers, websites, surveys and studies mentioned in the References section.
Methods of analysis and comparison were the primary research methods in writing this paper. By analysing accounting regulations, we found weaknesses in legislation that created the scope for accounting information manipulation. We analysed motives for true and fair view misrepresentation, identified and compared the techniques of true and fair view misrepresentation in terms of the difficulty of their application and in relation to the degree of true and fair view misrepresentation. Based on the analysis, we present the methods currently used to detect material incorrectness in financial statements.

3 Results and Discussion

3.1 The motives of true and fair view misrepresentation

The concept of creative accounting is used in practice and in literature for the purposeful misrepresentation of information contained in financial statements. We see the following differences between creative accounting and accounting as creative work activities: creative accounting is looking for ways and methods to transform the reality of the entity's business activity into the desired form, as opposed to a situation when accountants need to be creative in order to give a true and fair view in a situation when legislation allows to choose a solution from several alternatives or when legislation does not define the problem at all or problem is defined, but does not solve it or there is no regulation for the problem. Creative accounting has different forms and outputs, while there are a number of motives for it (Stangova and Vighova, 2017). Creative accounting forms the line between alternative approaches allowed by regulation and fraudulent financial reporting.

In this context, questions arise as to what are the main reasons for the fact that the generally accepted true and fair view principle is so often violated and who is most interested in correcting reality to a desired state? Statistics show that up to half of the perpetrators of economic crime are internal employees, mainly at an executive management or board level (PWC, 2014). Many of the fraudulent activities investigated have occurred in large multinational or domestic companies. However, a significant proportion of the fraudulent activity was also committed in small companies. Large companies attract perpetrators, especially due to their size. It is the size of the company that allows them to cope better with the losses caused by fraudulent conduct. For small companies, the reality of fraud often poses a threat to their existence.

The causes of true and fair view principle include in particular the interest of the company*'s* management by presenting the fulfilment of its tasks to prove its competence and thus to strengthen its position in the company; increase/decrease the profit or loss; a change in the market price of shares owned by employees, owners and management; to meet the disproportionately positive expectations of financial market participants and thus to strengthen the company*'s* position; the over-involvement of managers in the company*'s* results; reducing the company*'s* tax burden in these countries where accounting is the basis for tax calculation; improving the company's access to external sources of financing; the need to eliminate the uncertainty and risk that business entails; situations when it is necessary to determine the business*'s value*; lack of respect for fundamental ethical principles (Taraba and Rusu, 2011). Another motivation is in countries where financial markets are functional and another motivation is in countries where financial markets are underdeveloped and accounting forms primarily the basis for tax calculation. This is also linked to the business financing system. In countries with a functional financial market, investors invest their money in a business not only because of dividends payment but also because of the possibility to sell their shares at a higher price later. In countries where companies obtain money mainly from banks, the emphasis is mainly on the presentation of the company's indebtedness and the company*'s* ability to pay its liabilities, while creditors are particularly interested in their creditor*'s* risk.

3.2 The techniques for true and fair view misrepresentation

It is possible to achieve a better or worse view of the company*'s* financial situation, performance or changes in financial situation instead of the true and fair view, both through window dressing techniques - purposeful manipulation of data that are more or less obvious, as well as using off balance sheet financing techniques that require high professional qualifications and that are even difficult to detect by the auditors themselves (Atagan and Kavak, 2018).

The window dressing techniques are based on such accounting operations that result in the financial statements giving a misleading or unrepresentative view of the company*'s* financial situation, performance or changes in financial situation (Remenaric, Kenfelja and Mijoc, 2018). The main window dressing techniques include in particular: intentional misreporting of current assets in non-current assets and short-term liabilities in long-term liabilities and vice versa; recognition of assets that do not comply with the definition of an asset and the non-recognition of assets that meet the definition of an asset; sale and leaseback transactions; an intentional failure to comply with the prudence principle and matching principle in accounting; deliberately misrepresented estimates; deliberately misrepresented initial measurement of assets and measurement subsequent to initial recognition as well as abuse of the possibility of assets′ revaluation, misrepresented of revenue presentation; fictitious supplies of merchandise; issuing false invoices and inconsistent solutions to problems that occur in theory and practice. The window dressing techniques also serve to manipulate the company's income tax base.

The off balance sheet financing techniques result in the recognition of assets and liabilities in the balance sheets of other entities but in standard circumstances, the assets and liabilities should be recognised in the balance sheet of that entity. These techniques look for such financing method that is not presented in the balance sheet as a liability despite the fact that the entity receives funds from external sources. By these techniques, entities attempt to achieve a low level of indebtedness and appropriate ratio of liabilities to equity. The off balance sheet financing techniques include, for example, the deliberate conversion of finance leases to operating leases or the classification of loans as an equity (Drábková, 2017).

An interesting alternative to the classification of creative accounting methods is offered by Drábková (2011). She divides the misrepresentation techniques according to the degree of manipulation. In total, she divided this manipulation into three degrees in the Czech environment. The first degree is a positive and essentially harmless form of manipulation of financial statements. This manipulation represents methods of measurement assets,

impairment assets, recognition provisions and timing of company operations. They are within the legal framework of the relevant legislation. On the other hand, an entity presents information in the financial statements in accordance with the interests of those who have prepared it. It is important that these techniques do not significantly misrepresent the true and fair view. The second degree represents the use of such methods which are capable of significantly misrepresenting a true and fair view. This degree of adjustment of the information presented in the financial statements is at the threshold of creative and fraudulent accounting. The third degree of information adjustments already represents creative accounting in the form of fraudulent accounting. An entity deliberately omits certain information, does not provide true information or reports information or facts which have not occurred or are simply not true.

The misrepresentation techniques can be both within the legal framework and outside the legal framework of accounting legislation, when the entity acts in violation of current accounting regulations (Lennox and Pittman, 2010). Most of these techniques are on the verge of a link between creative accounting and fraudulent accounting. When assessing techniques for misrepresenting a true and fair view, it is important to distinguish between intentional and unintentional information misrepresentation.

3.3 The detection of true and fair view misrepresentation

In this part of the paper, we will focus on such misrepresentation of a true and fair view, that arose from an intentional violation of current accounting regulations, i.e. that which constitutes accounting or tax fraud. In order to assess whether incorrectness in the financial statements are of error or fraud, it is important to know the definition of fraud. Fraud is an intentionally misleading presentation of a material fact which the cheated entity trusts and on the basis of which it acts to its own detriment (Tumpach, 2008).

The most frequent detection method of fraudulent practice is the announcement of fraud. Fraud can also be detected on the basis of an examination by management, external and internal auditors or even at random or by confession by the perpetrators themselves (ACFE, 2012). According to a global fraud study, up to 50% of announcements of fraud are from employees. In our opinion, this may be due to the support of the whistle blowing method promoted in the USA. The US Securities and Exchange Commission provides whistle-blowers with a reward based on the size of the fraud. The ethical and moral behaviour of employees also plays an important role in detection of fraud. Companies should therefore emphasise the disadvantages of creative accounting and the need to obtain information on fraudulent practice, as these lead to the detriment of the company or its eventual liquidation due to the distrust of a company.

The traditional detection method of misconduct or fraud is a red flag. The red flag is an unusual circumstance or a pattern of anomalies that should alert a reasonable person of possible misconduct. In each such instance, further inquiry and due diligence might be necessary to determine if the anomalies are explainable and if not, an investigation should be considered. Not every red flag means there is fraud. There are some common red flags to consider: autocratic management style; unusual timing of transactions; frequency of transactions; unusual amounts recorded; missing or altered documents; no original documents available; documents that conflict with one another; questionable or missing signatures on documents; unusual documentation or payment arrangements, including sizeable commissions or fees or payments to third country bank accounts; activities in a tax haven country or a „high corruption risk" country identified on Transparency International's Corruption Perception Index; lack of controls in general; lax rules regarding authorization of transactions; inadequate income for lifestyle; changes in behaviour; contradictory behaviour, or recurring negative behaviour patterns, personal or family relationships between employees or contractors (Marks, 2020). The disadvantage of the red flag method is that many warning signs are already well-known nowadays and therefore an experienced perpetrator can quite easily avoid them.

At the present time, there are various complicated statistical and mathematical methods or data collection techniques that can identify hidden, unusual or deviating patterns

indicating fraud (Kubaščíková, Tumpach and Juhászová, 2019). These are various analytical models used to detect possible accounting errors and frauds. Popular and extended models include, for example, the CFEBT model, Beneish's M-score, Altman's Z-score, Benford's Law. There are some own sophisticated systems for the detection of errors and fraud in forensic audit companies as well.

An accounting entity's sophisticated internal control system of accounting is principal in detecting accounting errors and fraud. Its functionality should be examined by the entity's employees, including internal auditors and members of the supervisory board. Accounting provides information for supply, production and marketing processes checking of the entity, for economy and efficiency checking, financial discipline checking or the disposal of assets (Warren and Young, 2012). Accounting has a number of its own control elements that allow both preventive and subsequent control of various economic phenomena. In this respect, accounting is characterized by checking the formal and factual compliance of accounting, e.g. checking the formal and factual compliance of accounting documents, checking accounting entries compliance, the examination of the admissibility of accounting transactions contained in accounting documents, checking that all accounting transactions are booked, the realization of reconciliation procedures, checking the compliance analytical records with the main records. The subject of the factual compliance of accounting is so broad that it is not possible to define it exhaustively. An important tool of the internal control system is also the creation, subsequent implementation and checking internal accounting regulations of the accounting entity. It is known that the lack of an internal control system contributes greatly to the emergence of fraud. We think this is because internal employees in senior positions are often involved in fraud. These employees are responsible for the control environment in the given company and therefore know intimately how the internal control system works and how to deceive it.

Conclusions

The paper clarifies frequent motives, approximates the main techniques and presents the methods currently used to detect the misrepresentation of the true and fair view to be provided by financial statements. The motives, techniques or detection methods listing cannot be exhaustive because those responsible for the misrepresentation are very creative and are constantly looking for new ways to meet their goals. The misrepresentation of information on the economic activity of an economic entity has always been present. The motives for misrepresentation are practically immutable but the techniques for its implementation and detection methods are constantly being improved. The idea that the misrepresentation of information on an entity will disappear is naïve, albeit very pleasant. We could then trust all the information contained in financial statements.

It is well-known that the motive, opportunity and perception of the risk of sanctions as being low are among the factors contributing to the risk of misrepresentation of any kind. Eliminating all of these factors will significantly contribute to ensuring that the financial statements provide a represented, i.e. true and fair view of the economic activities of accounting entities. In order to prevent misrepresentation, it is desirable, in particular, to strengthen the independence of the entity's accounting from its executive management, make the internal control system more effective, apply generally accepted accounting principles consistently, strengthen the link among the information presented in the various components of the financial statements and to eliminate the possibilities of choosing from several different bookkeeping, measurement and presentation alternatives for the same transactions at a legislative level (Tumpach, 2008). The establishment of an anonymous company hotline for the announcement of unfair activities, raising awareness of the ethical aspects of the activities of all employees of the entity authorized to order, approve and examine economic transactions, including the senior management and persons responsible for accounting information processing at all levels, organising training for the application of basic ethical rules at all levels of joint responsibility for a true and fair view are also effective tools in the prevention of true and fair view misrepresentation.

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