Chapter 7: Results of the literature study, the analytical research and the questionnaire

7 Results of the literature study, the analytical research and the questionnaire

7.1 Introduction
This chapter describes the results that were obtained from the literature survey, the analytical survey of various companies and the questionnaire. Firstly the outcomes of the adjusted ratios are discussed, whereupon the responses to the various questions stated in the questionnaire are analysed. The chapter closes with some general comments provided by respondents to the questionnaire.

7.2 Literature study
Most of the literature that was consulted in the research to this dissertation, support the statement that the information generated from book entries seriously affects the integrity of financial statements. Many authors (Ellis and Williams 1993; Griffiths 1995; Mulford and Comiskey 2002), and researchers have different names for the use and misuse of book entries. It is called “the financial numbers game”, “creative accounting” and “smoothing of income”.

The truth of the matter is that book entries may be used to manipulate financial statements in order to reach a certain result. In this way companies have a powerful strategic tool with which they may influence decisions taken by internal as well as external stakeholders.

The following statements and quotes from the literature study emphasise the hypothesis that was stated in Chapter 1. The statements and quotes may be classified into three broad categories:
1. Users of financial statements and their information needs

According to Lee (1984) more attention is devoted to the challenges of financial reporters and auditors than to the needs of the users of financial reports. The use of profit in distribution is one of the decision-making areas that is based on a man-made construct with no tangible form. Lee also claims that formal accounting practices do not provide sufficient information regarding the liquidity position of the company.

The Brigham Young University has started to implement a business events approach to the accounting curriculum and their views on information supplied to users boil down to claims that the information views of financial statements are not uniform or stable. When focusing on the event, information portrayed in the financial statements, may be much more uniform and stable. In accounting the biggest problem that is faced information wise, is the number of different users that are concerned, each with a specific set of decision-making responsibilities. Accounting professionals may be seen as chief business information providers and as business problem solvers (BYU Junior Core Faculty 2003).

One of the principles of accounting is the communication of information. The purpose is to provide measured and reliable information to decision makers to increase their knowledge and reduce their uncertainty about the future (Lee 1984). The information that is provided must furthermore be relevant to be useful. When information is relevant, it ought to be able to influence the behaviour and actions of the recipient, thereby influencing the recipient’s decision.

2. Manipulation of information portrayed in the financial statements

“The potential for companies to transfer profits between years by the use of provisions [book entries] means that the use of this accounting procedure should be examined with care” (Ellis and Williams 1993).
“Cookie jar reserves: An overly aggressive accrual of operating expenses and the creation of liability accounts done in an effort to reduce future-year operating expenses” (Mulford and Comiskey 2002).

“Also bear in mind that the measurements of accounting events are not always objective. In this connection we must be aware of the possibility of manipulation of accounting data, and that great creativity can be involved” (Kinserdal 1995).

“Knowing that astute analysts will compare their depreciation policies with competitors’ practices, companies commonly represent accounting changes in this area as efforts to get into line with industry norms. They do not ordinarily stress another plausible motive, a desire to pump up earnings” (Fridson and Alvarez 2002).

“Unfortunately for analysts, companies do not always spell out in the Notes to Financial Statements the means by which they have artificially inflated their revenues” (Fridson and Alvarez 2002).

“If management wishes to impart a smoother appearance to the reported stream of “ordinary income before extraordinary items”, it can use whatever discretion it has in the classification of nonrecurring items to achieve its objective” (Barnea et al. 1976).

“Funny money is alive and well on Wall Street. Companies that rely on non-cash barter deals for revenue growth are getting taken to task” (Business 2.0 2003).

3. The use of allocations and provisions in the financial statements

“Most amounts reported on income statements and disclosed for non-monetary assets are the results of allocations” (Thomas 1975).

“The use of provisions has become commonplace and the big problem this causes for users of accounts is that they weaken the already tenuous relationship between the
All the above statements emphasise that book entries are used to change the integrity of information portrayed in the financial statements. The techniques employed to bring about such changes include classification, earnings management, allocation, income smoothing, cookie jar reserves, conservatism and change in policy. The usefulness of information for outside stakeholders is subsequently influenced because the above practices are all implemented through book entries.

7.3 Analytical research
The analytical research was based on the 30 companies listed in Chapter 6 and the analysis of the financial statements of these companies is presented in Appendix C. The results presented in this chapter were compiled from this research.

7.3.1 Ratios affected by reclassifying depreciation and deferred taxation

(1) & (2) Return on investment and return on equity
Return on investment as well as return on equity is a measure of the profitability of a company. With both the return on investment and the return on equity the profitability of the companies decreases when the adjustment is made. The deviation between the two ratios (traditional and adjusted) is substantial even though no company’s adjustment is above 66%. An analysis of the deviations is given below.
Table 7.1: Analysis of deviations in return on investment and return on equity ratios

<table>
<thead>
<tr>
<th>Analysis of deviation in ratio (%)</th>
<th>0 - 33</th>
<th>34 - 66</th>
<th>67 - 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies: return on investment</td>
<td>28</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>Number of companies: return on equity</td>
<td>20</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>Number of companies: fixed assets to equity capital</td>
<td>2</td>
<td>7</td>
<td>21</td>
</tr>
</tbody>
</table>

(3) Fixed assets: equity capital
When the fixed assets to equity capital ratio is more than 1:1 it means that a portion of fixed assets are financed with debt. In 20 of the 30 cases, the ratio showed that the companies had financed more of their fixed assets out of debt than before the adjustment. This indicates that these ratios are influenced by book entries that may influence the integrity of the information and in turn future decisions to be taken by the company.

(4) Cost of capital
In all instances the total debt of the 30 companies used in this research was not a substantial amount when compared to equity capital. The reclassification of deferred taxation and accumulated depreciation therefore had little or no influence.

(5) Long-term-debt-to-total-equity ratio
The long-term-debt-to-total-equity ratio measures the relation of debt to capital resources, in other words, it measures the credit financing to equity financing. This ratio was first applied in the traditional way to the information given by the 30 companies. In the second instance, deferred taxation was deducted from debt and classified together with accumulated depreciation as part of equity. In all instances, the companies' credit financing is now less than the equity financing. The traditional ratio emphasises that
owners contribute a larger share of the financing of the companies than outside creditors. When the ratio is adjusted, the shareholders are now contributing even more to the financing of the company than was previously the case. Table 7.2 summarises the deviations between the traditional and adjusted ratios.

Table 7.2: Analysis of deviation in the long-term-debt-to-equity ratio

<table>
<thead>
<tr>
<th>Analysis of deviation in ratio</th>
<th>0 - 33</th>
<th>34 - 66</th>
<th>67 - 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies</td>
<td>13</td>
<td>17</td>
<td>0</td>
</tr>
</tbody>
</table>

Fairly large deviations are recorded over a five-year period. In the case of 17 companies the ratio deviates between 34% and 66%, which is quite substantial. A company may definitely make different decisions when using the adjusted ratios and banks may be more prepared to consider companies requesting a loan.

(6) Gearing ratio
A company makes use of the gearing ratio when they want to measure the extent to which they make use of borrowed funds to finance their capital base. If the gearing ratio is high, it can be said that the company is predominantly financing its assets by debt. When the gearing ratio is low, it suggests that the company is primarily financing its assets from shareholders' funds. It is important to remember that the balance sheet figures used in the denominator of the gearing ratio and the debt-equity ratio are open to considerable manipulation (Ellis and Williams 1993). Firstly, the ratio was used in the traditional way. Secondly, the ratio was adjusted to accommodate deferred taxation in the equity figure. All of the 30 companies used in this research showed better results for the gearing ratio after the adjustment. In the third instance the ratio was adjusted to accommodate deferred taxation as well as accumulated depreciation in the equity figure, resulting in an even more favourable ratio. These results are given in Table 7.3.
Table 7.3: Analysis of deviation in the gearing ratio

<table>
<thead>
<tr>
<th>Analysis of deviation in ratio</th>
<th>0 - 33</th>
<th>34 - 66</th>
<th>67 - 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies: 1st adjustment</td>
<td>19</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Number of companies: 2nd adjustment</td>
<td>10</td>
<td>14</td>
<td>6</td>
</tr>
</tbody>
</table>

The ratio deviation shows two-thirds of the companies with a better gearing ratio, with a deviation between 0% and 33%, and one-third between 34% and 100%. In the second case, the decrease in the ratio is divided into roughly equal parts.

(7) Book entries as a percentage of crucial elements in the financial statements

A good accountant makes use of a small number of book entries. This was true of the past and still prevails today (Kocks 2003). In 16 of the 30 cases, the percentage of book entries is more than 42% of equity. This may be an indication that much of the information that companies “create” by using book entries, has a different integrity than information created by real transactions. The percentage rises above 100% for three companies and even as much as 205% for one company (see Appendix C). If book entries, based on artificial transactions, are just more than twice the value of a company's equity it is evident that the integrity of the information based on book entries may be severely influenced. Table 7.4 depicts these results.

Table 7.4: Average deviation analysis - book entries as a percentage of equity

<table>
<thead>
<tr>
<th>Average deviation analysis</th>
<th>Below average</th>
<th>Average</th>
<th>Above average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book entries as a percentage of equity</td>
<td>&lt;</td>
<td>38 - 42</td>
<td>&gt;</td>
</tr>
<tr>
<td>Number of companies</td>
<td>9</td>
<td>5</td>
<td>16</td>
</tr>
</tbody>
</table>

The percentage of book entries to cash from operating activities and the percentage of book entries to profit attributable to shareholders, are related. These two percentages become very high for some companies, hence it follows that the integrity of information is impaired. In the case of nine of these companies the percentage rises above 100%,
and even turns out to be more than 1000% in the case of one company when book entries are compared to the profit attributable to shareholders. If managers rely on information created by book entries then it follows that the decisions may be influenced in such a way that it is likely to be harmful to other stakeholders. Table 7.5 presents this information.

### Table 7.5: Average deviation analysis - book entries as a percentage of turnover, cash from operating activities and profit attributable to shareholders

<table>
<thead>
<tr>
<th>Average deviation analysis</th>
<th>Below average</th>
<th>Average</th>
<th>Above average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book entries as a percentage of turnover</td>
<td>&lt; 3 - 6</td>
<td>&gt;</td>
<td></td>
</tr>
<tr>
<td>Number of companies</td>
<td>11</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>Percentage of cash from operating activities</td>
<td>&lt; 20 - 24</td>
<td>&gt;</td>
<td></td>
</tr>
<tr>
<td>Number of companies</td>
<td>8</td>
<td>2</td>
<td>20</td>
</tr>
<tr>
<td>Percentage of profit attributable to shareholders</td>
<td>&lt; 20 - 24</td>
<td>&gt;</td>
<td></td>
</tr>
<tr>
<td>Number of companies</td>
<td>5</td>
<td>3</td>
<td>22</td>
</tr>
</tbody>
</table>

Book entries make out a substantial amount of the majority of the crucial elements (e.g. equity) of financial statements. If information is based on so much subjectivity (book entries), its integrity may be influenced quite substantially. The influence of the reclassifying of book entries also has a substantial effect on the outcome of the adjusted ratios. Book entries must therefore be handled with great care.

#### 7.3.2 Ratios used with reference to internal funds

One of the objectives of this research is to show that the depreciation provision does generate internal funds.

Ratios developed by Martínez Bobillo et al. (2002): These ratios measure the ability of a company to generate internal funds (Refer section 6.3.1, point 8). The mean of the 30 South African companies is measured against the mean of European companies.
Table 7.6: Results of internal fund ratios (Martinez Bobillo 2002)

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment effort for the period (INVEFF) - Europe</td>
<td>0.07701</td>
<td>0.17113</td>
<td>-0.74021</td>
<td>3.35540</td>
</tr>
<tr>
<td>Investment effort for the period (INVEFF) - South Africa</td>
<td>0.41168</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales Accelerator (SIFA) - Europe</td>
<td>0.16557</td>
<td>0.54460</td>
<td>-2.45723</td>
<td>2.48744</td>
</tr>
<tr>
<td>Sales Accelerator (SIFA) - South Africa</td>
<td>0.99332</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capacity to generate funds (CFFA) - Europe</td>
<td>0.13629</td>
<td>0.10222</td>
<td>-0.23159</td>
<td>0.49321</td>
</tr>
<tr>
<td>Capacity to generate funds (CFFA) - South Africa</td>
<td>11.54836</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

INVEFF = The mean of the South African companies is 0.41168 compared to the European mean of 0.07701. The South African companies' investment effort appears to be better than that of the European companies.

SIFA = The mean for Europe is 0.16557 and for South Africa is 0.99332. This suggests that South African companies’ sales are accelerating more than those of the European companies.

CFFA = The mean for Europe is 0.13629 and for South Africa is 11.54836. South African companies therefore have the capacity to generate internal funds to a greater extent than European companies.

South African companies are performing better than the European companies in the sense that they are more able to generate internal funds, more able to accelerate their sales and their effort to invest seems to be higher. It therefore follows that the majority of South African companies may be able to make use of internal funding rather than external funding.

Working capital: When deducting the accumulated depreciation from the current assets in the working capital ratio and adding back the fixed asset replacement costs, most companies are unable to cover their current liabilities. The main reason for this is the
fact that the internal fund is hidden in the working capital and therefore companies use the internal fund for operating activities. When the company has to finance the replacement of their fixed assets, they have to make use of external funding that is probably more expensive than internal funding.

When referring to the results of the ratios from Martinez Bobillo (2002) presented above, it is clear that the companies have the ability to generate internal funds. But, when the adjustment of the working capital takes place, it seems if though the companies are not aware of this capacity to generate internal funds, or because the internal funds are hidden in the working capital, they are applying the internal funds for normal operating activities.

7.4 Questionnaire
The questionnaire and the covering letter that were sent to the financial managers of the listed companies are reproduced in Appendix A and Appendix B respectively.

7.4.1 General
A total of 64 completed questionnaires was received at the cut-off date. Some of the respondents had obviously made a big effort to contribute to this research. Despite some differences in opinion among the respondents, by far the majority of responses seemed to underline the validity of this dissertation, namely, that book entries affect the integrity of information.

The other responses received may be classified as follows:
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Table 7.7: List of responses

<table>
<thead>
<tr>
<th>Response</th>
<th>No of responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>De-listed company</td>
<td>1</td>
</tr>
<tr>
<td>Deregistered companies</td>
<td>3</td>
</tr>
<tr>
<td>Forwarded to someone else</td>
<td>11</td>
</tr>
<tr>
<td>Incomplete questionnaire</td>
<td>2</td>
</tr>
<tr>
<td>Policy of non-participation</td>
<td>10</td>
</tr>
<tr>
<td>Out of office</td>
<td>5</td>
</tr>
<tr>
<td>Refraining</td>
<td>4</td>
</tr>
<tr>
<td>Financial manager retired</td>
<td>1</td>
</tr>
<tr>
<td>Financial manager of two listed companies</td>
<td>3</td>
</tr>
<tr>
<td>Busy with year-end or too busy to partake</td>
<td>6</td>
</tr>
</tbody>
</table>

Given this feedback, a response rate of 40.36% was achieved of the 384 possibilities. If the e-mails that had failed, had been blocked or quarantined are not taken into account, a response rate of 31.86% was achieved.

7.4.2 The definition of a book entry

Of the 64 responses received, 50 respondents attempted to define a book entry. One of the useful definitions of a book entry was “An entry that does not have a real (eventual) cash effect on assets or liabilities of the entity and is subject to reversal in certain instances”. An example of a less useful definition of a book entry was “A journal debit with a corresponding credit”. Some respondents could cite examples of book entries but did not supply a definition.

The following is a list of the definitions received from the respondents in the order of the most useful to the least, according to the author’s frame of reference:
A. Most useful definitions:

(1) “An entry that does not have a real (eventual) cash effect on assets or liabilities of the entity and is subject to reversal in certain instances. Examples are provisions (depreciation, bad debts, future costs, warranty, and write-offs on inventories), revenue recognition, amortisation, etc”.

(2) “Book entries happen because accounting realities need to be recorded and cannot be processed through debtors and creditors ledgers or (initially) the cash book. Some eventually do make it through the cashbook, e.g. when the outside shareholder eventually pays back his loan to the company or gets paid his share of profits and some never make it to the cash book directly, e.g. deferred taxation timing differences transactions or writing off goodwill. GAAP insists that they all get recorded”.

(3) “A book entry is [a] journal entry adjusting the carrying value of assets either up or down or providing for an expense where a quantifiable and highly probable exposure for loss exists. Thus book entries should make a set of accounts more relevant and reliable to a user”.

(4) “One that does not have a cash impact, due to timing or other accounting conventions”.

(5) “An accounting journal entry passed to create an accounting effect different to the effect of pure cash flows. It is normally an attempt to recognise timing of events in different periods to make the cash flows happen”.

(6) “Transactions/Journals that do not involve an outside party [for example] creating provisions, accruals etc.”.
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(7) “Journal entries to either (i) provide non-cash transactions or (ii) reclassify”.

(8) “A journal entry used to create or adjust the carrying value of an asset or liability or to change its classification”.

(9) “A journal entry that is not supported by a cash transaction - may be a reclassification/disclosure entry for example, or recording of an unrecognised foreign exchange gain/loss etc.”.

(10)”A book entry is a non cashflow adjustment to financial statements. The adjustments could be for [example] depreciation, provision for bad debts, adjustments to debtors and creditors etc.”.

(11)”Any entry not reflective of an immediate cash flow transfer of asset or liability”.

(12)”An entry not reflecting a cash flow or legal obligation”.

(13)”A book entry is a journal entry which adjusts profits either up or down in accordance with the wishes of management. It is usually reversed immediately after a report has been finalised and has no underlying basis for the transaction. It is usually a transaction which has no impact on the cash flow statement”.

(14)”Entry processed by way of journal to account for transactions which did not initiate through the cashbooks, sales or purchase documents. Does not mean that it is an artificial transaction”.

(15)”Any non-cash entry - i.e. not made through the cash book”.
(16) “Journal entry that does not directly impact on cash flow. (And is susceptible to manipulation)”.

(17) “A book entry “journal” should only be done to affect corrections or accruals and/or provisions. The accruals must comply with GAAP”.

(18) “This is a high-level adjustment put through”.

(19) “Adjustments taken into account not based on physical cash or account transactions”.

B. Moderately useful definitions

(20) “Adjustment to reflect financial transactions which involve judgement and are based on managements preferences”.

(21) “An entry (within GAAP allowances) that is made to get a certain result”.

(22) “Book entry is a journal which is put through to correct information, or to disclose a balance sheet item correctly, [for example] depreciation, restating export debtors, provisions etc.”.

(23) “A journal entry, to bring into account at a month or year end, an increase or decrease in Income, Expenditure, Asset or Liability. Eg. Creating provisions for bad debts is not an exact. There is always room for manipulation”.

(24) “An entry made to correct or establish information that is known but un-entered or provided for”.
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(25) “Recording of historic transaction, on an accrual basis”.

C. Examples of book entries rather than definitions

(26) “Journal entry [for example] depreciation, provision, correction of mistakes and note descriptions”.

(27) “Provisions, accruals, restructuring charges, etc.”.

(28) “Provision, reserve, reclassifying entries which affect earnings and/or disclosure”.

D. Least useful definitions

(29) “An accounting entry not necessarily arising from business operations (i.e. being processed through the operating systems of the business), but being manually recorded in the general ledger”.

(30) “Non-regular adjustment in the accounting records of the entity, done through a journal entry (i.e., a transaction that does not flow from a normal transaction stream)”.

(31) “Adjusting the accounts with an entry that was not generated in the normal course of business”.

(32) “An entry put through the books to create a desired result for a certain party”.

(33) “An entry created to reflect what management wants the information to reflect”.

(34) “A journal entry required to reflect the corrected position of non-routine items in the
trial balance and ultimately the [annual financial statements]”.

(35)“In this context, any entry not reflecting a historical fact”.

(36)“A transaction outside of normal transaction streams of a company”.

(37)“Journal entry done to comply with GAAP for transactions not having for example invoices, receipts, cheques, etc. as source documentation”.

(38)“Any record of any transaction”.

(39)“Recording of a transaction or event”.

(40)“A journal entry that corrects errors or is not the subject of a sales/purchases/cash transaction”.

(41)“[A] book entry is [an] entry that has no supporting documentation and [does] not comply [with] GAAP”.

(42)“[An] entry that satisfies the definition criteria as set out in the accounting framework AC000 and conforms with GAAP”.

(43)“Journal entry”.

(44)“Necessary entry to give effect to economic reality”.

(45)“Any entry into the financial accounting system”.

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(46) “The automatic recording source for transactions - sales, purchases, bank movement etc into the general ledger - these arise automatically linked to the business process and are allocated to general ledger accounts automatically. Journal entries by contrast, are not source material transactions, but are used to correct/adjust automatic entries flowing directly to general ledger designated accounts”.

(47) “Any alteration to the account balances in the general ledger, or any of [the] subsidiary ledgers”.

(48) “An entry that is not electronically generated through a sub-system”.

(49) “Journal entry supported by evidence”.

(50) “A journal debit with a corresponding credit”.

It became clear from this survey that very few of the respondents are familiar with the concept of a book entry. It is quite alarming to observe the lack of knowledge of book entries that exist among the respondents given that it is used in accounting on a daily basis. The first 25 definitions are more or less useful. Definition 26, 27 and 28 are actually just examples of book entries. A book entry is an important tool for the accountant and therefore an urgent need for a definition and a description of a book entry is justified.

7.4.3 Responses to each statement

A discussion of the responses received to each statement in the questionnaire is presented below, using the following legend:
Question 1: Book entries precipitated as journal entries may be used to manipulate financial information.

Response 1:

<table>
<thead>
<tr>
<th>All</th>
<th>Analyst</th>
<th>Financial manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>SA</td>
<td>A</td>
<td>U</td>
</tr>
<tr>
<td>41</td>
<td>39</td>
<td>2</td>
</tr>
</tbody>
</table>

To *manipulate* means to operate on or handle with skill, manage or control skilfully by using one’s influence or unfair methods (Hornby 1981).

The following issues arise from the above responses:

1. Book entries are not normal transactions and may influence the financial statements positively or negatively.
2. Book entries are based on perceptions and perceptions may influence the information contained in the financial statements.
3. Book entries are powerful tools at the disposal of an accountant. Therefore, these must be handled with the greatest caution.
4. From the above it follows that book entries influence the integrity of information.
Question 2: Classifying items in the balance sheet may be used to manipulate financial information.

Response 2:

<table>
<thead>
<tr>
<th>All</th>
<th>Analyst</th>
<th>Financial manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>SA</td>
<td>A</td>
<td>U</td>
</tr>
<tr>
<td>28</td>
<td>41</td>
<td>8</td>
</tr>
</tbody>
</table>

1. A total of 69% of respondents agreed that classifying items in the balance sheet may be used to manipulate financial information.

2. It also follows that the classification of items within the income statement may manipulate information. According to Mulford and Comiskey (2002), classificatory creativity within the income statement mainly involves the changing of the classification of individual income statement items within the income statement. This is done to change certain key subtotals within the income statement, thereby altering the reader’s perception of financial statements. The following methods can be followed:

   • Moving items to or from operating income.
   • Moving expenses from cost of sales to, for example, administrative expenses, thereby increasing gross profit.
   • Moving operations in and out of discontinued operations based on gains and losses of discontinued operations.

3. Information cannot be created by an accountant (cf. energy cannot be created – see section 3.3 in Chapter 3). Classification is used for ratios and must be used with great caution.
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(4) It follows from this response that the integrity of information is influenced by classification. Classification may also be viewed as a book entry.

**Question 3:** Classifying items for year-end statements can be viewed as reversible book entries.

**Response 3:**

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Analyst</th>
<th>Financial manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>SA A U D SD</td>
<td>SA A U D SD</td>
<td>SA A U D SD</td>
<td></td>
</tr>
<tr>
<td>15 36 11 27 11</td>
<td>22 22 12 44 -</td>
<td>14 38 11 24 13</td>
<td></td>
</tr>
</tbody>
</table>

(1) A total of 51% of the respondents agreed that classifying items for year-end statements may be viewed as reversible book entries.

(2) Items classified in the balance sheet for a year end is only for a moment. For example, stock is classified as a current asset for year end purposes and afterwards again seen as stock.

(3) Classifying items may be viewed as a book entry. Reclassifying an item may also influence the integrity of information.
Question 4: Providing for depreciation is one way of generating internal funds.

Response 4:

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Analyst</th>
<th>Financial manager</th>
</tr>
</thead>
<tbody>
<tr>
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(1) A total of 34% of the respondents agreed that providing for depreciation is one way of generating internal funds.

(2) Such a large variation in the response to this question may be due to respondents’ uncertainty about this issue. The question then is whether the respondents understand the concept of depreciation.

(3) There is a difference between accounting and financial management where depreciation is concerned. According to financial accounting text books, providing for depreciation is a way of creating an internal fund: “...the sum of depreciation and retained earnings (i.e., the cash flow) is an important source of finance” (Wilson, 1974:248). Accumulated depreciation provides a company with an internal fund to replace their fixed assets.
Question 5:  **Earnings management may have a negative effect on the integrity of information.**

Response 5:

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(1) A total of 66% of the respondents agreed that earnings management may have a negative effect on the integrity of information.

(2) Earnings management may be defined as “the active manipulation of earnings toward a predetermined target” (Mulford and Comiskey 2002:87). The parties responsible for setting this target usually include management acting on the grounds of a forecast made by analysts or the reasoning that a smoother income will be welcomed by investors.

(3) The negative manipulation of information may be done through classification or book entries. Tools that may be used are income smoothing or big baths.

(4) Some of the rewards of earnings management are defined by Mulford and Comiskey (2002) and may include:

- upward move in share prices
- improvement of debt rating
- boosting a profit-based bonus
- lower political costs, for example, avoiding high taxes.
(5) It is clear that, if the motivation for earning management is based on the above, the integrity of the information may be influenced.

**Question 6:** *Earnings quality should be measured in terms of its usefulness to the users.*

**Response 6:**

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(1) A total of 69% of the respondents agreed that earnings quality should be measured in terms of its usefulness to the users.

(2) Earnings quality is dependent upon integrity as determined by the use of book entries, classification and earnings management.

(3) Analysts agree more on this aspect than financial managers, as their positive response was 78%.

(4) If users rather than the compilers of financial statements determine the quality of the earnings this would be to the detriment of higher incentive bonuses for managers.

(5) The integrity of the information related to earnings quality may be influenced when book entries are used to the benefit of management.
Chapter 7: Results of the literature study, the analytical research and the questionnaire

**Question 7:** For decision-making purposes, the cause and effect of a book entry must be considered.

**Response 7:**

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(1) A total of 83% of the respondents agreed that for decision-making purposes, the cause and effect of a book entry must be considered.

(2) Given the response to question 4 where 34% of the respondents agreed, and the positive response to this question (83%), it is clear that the effect of a book entry is not understood by all the respondents.

(3) The analysts agree completely on this question (100%) whereas they only agreed to some extent in question 4 (44%).

(4) Cause is defined by Hornby (1981:133) as: “that which produces an effect”, whereas effect is defined as change produced by an action or a cause.

(5) The effect of depreciation is cancelled in the cash flow statement in order to calculate cash flow (recall that cash “represents reality” in this dissertation).
Question 8: The quality of earnings depends on the time between revenue recognition and cash collection.

Response 8:

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1. A total of 62% of the respondents agreed that the quality of earnings depends on the time between revenue recognition and cash collection.
2. Revenue recognition is when a transaction is not complete. The outcome is uncertain and has to be predicted.
3. Revenue recognition is a case of predicting the future, which negatively affects the integrity of information.
4. It is significant that there is such a big range of opinions between the parties who agree (62%) and those who disagree (32%).
5. The positive response indicates that the shorter the time between revenue recognition and cash collection, the better the quality of earnings.
6. The analyst gap is smaller: 56% vs. 44%. There seems to be uncertainty between the analysts.
7. Time is a phenomenon that influences the integrity of information. Matching brought time and future prediction into consideration.
8. A book entry underlying a time-oriented entry also simulates reality whereas cash represents reality.
Question 9: Book entries affect future reality.

Response 9:

(1) A total of 45% of the respondents agreed that book entries affect future realities.

(2) A world renowned analyst who gave evidence at the Enron trial, Baruch Lev, argued that “good financial reports should tell something about the future” (Lev, 2003). This can only be created through a book entry.

(3) Respondents do not seem to realise the effect of book entries and they are not future oriented.

(4) According to the respondents, book entries have little or even no effect on the integrity of information.

(5) It is clear from the fact that 37% agree while 35% disagree, that many respondents have rather outdated viewpoints.

Question 10: Earnings management is being used to increase investor confidence.

Response 10:
Chapter 7: Results of the literature study, the analytical research and the questionnaire

(1) A total of 64% of the respondents agreed that earnings management is being used to increase investor confidence.

(2) Both the analysts and the financial managers felt very strongly that earnings management may increase investor confidence.

(3) Earnings management is being used as well as misused to influence investors.

(4) Earnings management is brought about through the use of book entries.

**Question 11: Book entries may be used to present ‘big baths’ in earnings management.**

**Response 11:**

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(1) A total of 47% of the respondents agreed that book entries may be used to present big baths in earnings management.

(2) Because 27% of respondents were not clear on this issue, it is apparent that ‘big baths’ is not a well-known term among the respondents.

(3) The responses to this question clearly illustrate that book entries influence the integrity of information.

(4) According to Lev (2003) companies only start playing with numbers when they get into economic trouble. When playing with the numbers, book entries are used. They usually do not manage their earnings.

(5) Whether managers apply big baths or not, seems to be based to some extent on their perception of right and wrong.
Question 12: Book entries may be used to smooth income over the long term.

Response 12:

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(1) A total of 67% of the respondents agreed while 31% disagreed that book entries may be used to smooth income over the long term.

(2) From the response it is clear that respondents are more familiar with the term income smoothing than big baths.

(3) There is certainly agreement that book entries are used to smooth income over the long term, implying that such actions are future based. This is a deviation from question 9 where the respondents did not agree quite so strongly.

(4) Income smoothing is a tool that may be used by management to influence the future as well as the integrity of the information content of the financial statements.

Question 13: Investors are more confident when a company’s earnings rise gradually.

Response 13:

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Chapter 7: Results of the literature study, the analytical research and the questionnaire

(1) A total of 81% of the respondents agreed that investors are more confident when a company’s earnings rise gradually.

(2) Compilers of financial statements believe that investors are more confident with earnings rising gradually – 86% agreed.

(3) It appears that analysts do not really believe that investors are more confident when a company’s earnings rise gradually, since only 55% agreed with the claim put forward in the question. This might be because analysts view statements from the investors’ point of view.

(4) This statement pressurises compilers to conform to income smoothing rules and thereby using book entries to influence the integrity of the information.

(5) Analysts and compilers do not share the same perception on this issue. According to the analysts’ response it seems as though investors are not more confident when a company’s earnings rise gradually, this may be because they know the company is playing with the numbers.

(6) The high percentage of financial managers agreeing to this question reveals that companies will quite easily use income smoothing and thereby influence the integrity of the information.

**Question 14: Income smoothing can be used as a strategic tool.**

**Response 14:**

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(1) A total of 63% of the respondents agreed while 32% disagreed that income smoothing can be used as a strategic tool.
(2) Income smoothing is one method used to reach a company’s strategic goals.
(3) Income smoothing is used to manipulate the future results of a company.
(4) The strategy of a company may influence the integrity of information by making use of book entries.

**Question 15:** Income smoothing may be viewed as mixing good and bad news to the detriment of outside stakeholders.

**Response 15:**

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(1) A total of 60% of the respondents agreed that income smoothing may be viewed as mixing good and bad news to the detriment of outside stakeholders.
(2) Income smoothing is used to manipulate good (profits) and bad (losses) realities. When income smoothing is applied, the profit of one year is used to lower the loss of the previous year.
(3) Time is a primary concern when the previous year’s bad news can be reduced by a company restating its figures. Book entries are used to restate the figures of a company and also influence the integrity of the information presented in the financial statements.
Question 16: Book entries are based on artificial transactions.

Response 16:

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(1) A total of 11% of the respondents agreed that book entries are based on artificial transactions.

(2) Most respondents do not share the same view regarding artificial transactions. In essence a book entry can at best only simulate reality.

(3) There is a relationship with question 9 because of future uncertainty. Future uncertainty is also seen as part of artificial transactions.

(4) Book entries are the result of a decision to allocate to the future. Allocation is not a real event whereas cash represents reality. All future based “transactions” involve uncertainty.

(5) It is evident from the responses received that accountants view entries as a result of transactions, while entries as book entries are viewed as the same thing as real transactions.
Chapter 7: Results of the literature study, the analytical research and the questionnaire

**Question 17:** Information created through income smoothing has less integrity than that created by real events.

**Response 17:**

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(1) A total of 82% of the respondents agreed that information created through income smoothing has lesser integrity than that created by real events.

(2) Real events create information of higher integrity than book entries because book entries are based on subjective opinions of management.

(3) The quality of integrity is based on information created by real events.

**Question 18:** Information created through book entries is based on artificial transactions.

**Response 18:**

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(1) A total of 15% of the respondents agreed that information created through book entries is based on artificial transactions.

(2) This response is in line with the response to question 16, where 11% agreed. It
seems that the respondents are not familiar with the term artificial transactions.

(3) Book entries are not based on real events but rather on the subjective opinion of management.

(4) Respondents do not believe that book entries are based on artificial transactions; they believe they are based on real transactions. This viewpoint may be the result of many respondents not being clear about what a book entry is.

**Question 19: Book entries may seriously affect the integrity of information.**

**Response 19:**

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(1) A total of 56% of the respondents agreed that book entries may seriously affect the integrity of information.

(2) A total of 38% of the respondents disagreed on this question. This may be because the respondents do not know the term book entry as well as they should.

(3) Integrity of the information is influenced primarily by book entries.

(4) Analysts agree more strongly on this point as 67% agreed.

(5) Book entries are used to manipulate information. When earnings management or creative accounting takes place in a company, the integrity of the information may be impaired. Book entries are the main tool used to manipulate information.
Question 20: Only for real transactions and events is cash the main deliverable.

Response 20:

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(1) A total of 52% of the respondents agreed that only for real transactions and events is cash the main deliverable. Only 31% disagreed.

(2) An exception to the rule is credit sales where there is a strong degree of uncertainty on the realisation of cash. “While accounts receivable are recorded precisely, their collectibility is not known with precision, but with experience we can get a basis for an acceptable approximation” (Goldberg 1974).

(3) Cash is a very strong determinant of the integrity of the information.

Question 21: Subjective book entries are based on opinions, not facts.

Response 21:

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(1) A total of 53% of the respondents agreed that subjective book entries are based on
opinions and not facts.

(2) An opinion is perception driven. Book entries are based on the (subjective) opinions of management which may influence the integrity of the information portrayed in the financial statements.

(3) Analysts disagreed very strongly on this question, since 67% gave a negative response. It seems if analysts belief that book entries are based on facts. This may be because of a lack of understanding of the term book entry.

(4) It is evident that respondents find it difficult to distinguish between real transactions (reality) and opinions.

(5) Respondents do not take the future into consideration.

7.4.4 General comments received from the questionnaire

Some respondents took the time to give general responses to the questionnaire. The following responses were received and classified into five broad categories:

A. Respondents defending book entries:

(1) “Book entries can be valid journal entries and not just processed for a manipulation of earnings. Such entries may not influence the integrity of the financial information nor be based on artificial transactions”.

(2) “Your questionnaire seems to have an undercurrent of mistrust when it comes to processing a “book entry”. I certainly don't think there is anything sinister about the ones I process”.

(3) “In general manipulation of financial statements through creative accounting is only detrimental to investor decision-making when not disclosed and when the objective is to deceive the reader. Current accounting practices are trying to cover all events for all companies in all industries. This is not possible - note loan stock structures,
particularly in the property sector”.

(4) “This questionnaire is too simplistic and does not reflect what actually takes place when entries are passed in a company. The general tone of the questionnaire seems to ask whether the use of book entries are in the main for purposes of manipulation. This is certainly not the case. In companies who practise good corporate governance all entries, book or otherwise have checks and balances in place to determine their validating including instances where subjective elements are present. Do not forget that checks and balances also include external audit of all entries”.

(5) “Book entries may be necessary to account for timing differences in revenue or expense recognition and cash movements or to comply with accounting conventions [for example] depreciation. Although they can be used to manipulate results they are obviously not there for that purpose. [That is] “garbage in garbage out”. At the end of the day we must rely on the integrity of the management concerned and on the auditors to pick up the misuse of book entries”.

(6) “There are many “real” cashless transactions. To fail to show these would distort the picture the financial statement user receives. Subjective entries are based on non-definitive facts and judgement, not opinions (Refer question 21). The reliability of financial information relies on the integrity of the preparer or the persons instructing the preparer. Even so-called “hard” entries like cash book entries can be manipulated by the unscrupulous”. 

(7) “All adjustments to the [annual financial statements] must strictly adhere to GAAP and book entries is not there to “adjust or smooth” results”.

(8) “Book entries are not based on artificial transactions as there must be factual
information and circumstances to back up the entries and values”.

B. Comments regarding internal funds

(1) “I agree with the concept of depreciation. Book entries are purely historical. Earnings should reflect the cash position except for depreciation, which relates to long-term capex”.

(2) “Providing for depreciation is allocating costs across the use of the assets, it does not provide funds for replacement. I see it as working backwards to what was spent, rather than forwards to what may need to be spent in future. If management continued to raise a provision for depreciation beyond the period of write off of book value, then internal funds would be generated”.

(3) “Depreciation is an allocation of a money resource and therefore must assist in generating funds which are not distributed”.

C. Manipulation of information and corporate governance

(1) “Whilst it is possible to manipulate income by means of book entries, this should be expressly prohibited. Income smoothing, in my opinion, is a breach of ethics and good corporate governance and will definitely, if investors know about it, reflect poorly on an enterprise. Entries should be based on real information and real transactions and should not, under any circumstances, be manipulated in order to provide a different picture to analysts and investors. One of the principles of King II is that of transparency and this should be adhered to at all times”.

(2) “There is no question that book entries are utilised to manipulate information to the detriment of users”.

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(3) “Profits can be manipulated which might not be a true reflection of its performance. Book entries could be a very dangerous tool if not managed and controlled”.

(4) “Book entries are always within a “range” which creates some measure of flexibility, ethical rules govern rules therefor”.

(5) “Earnings are susceptible to manipulation by unscrupulous management as “earnings” is a key factor in evaluating financial performance and a key determinant of share valuation models and executive incentive schemes”.

(6) “If management want to manipulate results, book entries can be based on partially true information”.

(7) “JE’s may be used to hide all sorts of information and so manipulate information”.

(8) “Earning management is being abused. Small business is more flexible but public shareholders want to see consistent increases. Some industries want big increases [that is] IT”.

D. Comments regarding investors and the effect of income smoothing

(1) “Investors seem to prefer steady growth in earnings, rather than ups and downs. There is no alternative to an opinion, which is better than nothing (Refer question 21)”.

(2) “Investors prefer to invest in companies with steadily growing and predictable earnings. There must surely be some substance to journals passed and there are a lot of instances where judgement is required unless users are prepared to wait for months for exact information (eg medical aids, Travel industry, Life & short-term
(3) “The practice of using book entries as a “strategic tool” to manipulate earnings and investor behaviour is wrong. There are many ways to manipulate financial statements. Passing journals/book entries is one of the easiest. However, it is impossible to ban all book entries as they are essential to drawing up accurate and useful financial statements. It is also impossible to eliminate judgement and a measure of subjectivity in drawing up financial statements (Refer question 21)”.

(4) “Unexpected peaks in earnings makes investors wonder whether it is sustainable. Investors like a smooth, unexpected rise in income”.

(5) “Earnings may be “massaged” to avoid shocks to the market, but this does not necessarily reflect the underlying nature or reality of the transactions. In the long term however I believe that book entries cannot be used to consistently manipulate earnings. They can be used to manipulate short term reality but not long term reality, since in the long term earnings are cash. Quality of earnings depends on how closely cash and earnings match each other, whether the underlying transaction is recurring or non-recurring in nature, the degree of subjectivity/estimation/estimates in calculations of amount, consistency with accounting policies, transparency of note disclosures, degree in which amounts are subject to change etc”.

(6) “In general I feel strong that results should not be manipulated or smoothed as the history and trend information gets lost when trying to analyse future years’ results. Obviously journal entries can be used to manipulate and manage results, but these should be subject to stringent audit interrogation, both at year end and in the new financial year. This is particularly the case this year, where the rand has moved so
significantly - income smoothing should not be possible and the results should reflect actual position”.

(7) “Earnings management and earnings smoothing may misrepresent the true volatility of earnings generated by the business. This may make investors more comfortable with the business than they should be”.

E. Additional comments

(1) “It is the job of the financial director to keep the CEO in line”.

(2) Telephone conversation from Durban: “I am a financial manager of a listed company and do not like the idea of receiving a questionnaire addressed to nobody. I am not happy with the tone of this questionnaire. I would answer strongly disagree to all the questions. As a listed company we do not distort information. We follow GAAP strictly to the rule. Your questions are vague and I do not understand the meaning of artificial and subjective”.

(3) “Answers to questions are subjective totally dependant upon interpretation of what is being asked”.

(4) “Please note questions 1,2,3,5,11,12,14,15 19. The use of words 'may' and 'can' is confusing. It could mean either that it is allowed and approved or; as it is possible and could be done. I interpreted the latter”.

From the general comments supplied, the respondents do not seem to agree on the use of book entries and their influence. The majority of the respondents do, however, support the hypothesis of this research, namely, that the integrity issues of information created by real transactions is different to the integrity issues of information created by
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It also became evident that because some respondents are unfamiliar with some of the terminology used in accounting, their comments did not support the hypothesis.

The overall response to the questionnaire is positive and supports the hypothesis.

7.5 Conclusion

This chapter reported on the literature survey that was conducted, the analytical analysis that was undertaken of the 30 listed companies and the questionnaire that was sent to a large number of listed companies.

The results of the literature survey clearly support the hypothesis stated in Chapter 1, namely that the integrity issues of information created by book entries based on future events is different from the integrity issues created by real transactions.

Both the results of the analytical analysis and the responses from the questionnaire support the hypothesis. For example, calculations of book entries as a percentage of crucial elements in financial statements indicate that such entries make out a substantial amount of the majority of the crucial elements of financial statements. Therefore, such impaired information may lead managers into making incorrect, long-ranging decisions.

In the final chapter, the results obtained in this work is analysed in more detail and some conclusions for further research in this area is proposed.