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Conclusion and recommendations

8.1 Introduction

The study involved an investigation into the integrity of information created by book entries based on future events. An investigation was launched in earlier chapters to discover whether such integrity are the same (or not) as the corresponding integrity created by historical events, i.e. real transactions realised over time. The most important findings of this research, addressing the above question, were presented in Chapter 7. In the current, final chapter of this dissertation these findings and conclusions are summarised and the contribution of this work is stated in the context of the hypothesis given in Chapter 1. The chapter concludes with some recommendations for the accounting profession.

8.2 Contributions of this work

After the analysis of the 30 companies was conducted and the responses to the questionnaire were available, it became evident that there is a need for much more transparency in the financial statements of a company.

Recall that the following hypothesis was stated in Chapter 1:

The integrity of information created by book entries is based on subjective opinions because it is based on future events therefore it is not the same as integrity of information created by real transactions that is based on historical events.

The validity of this hypothesis was tested and the following presents conclusions from the research which emphasise the validity of the hypothesis:

A. Information and its characteristics

- The accounting framework introduces four qualitative characteristics, namely, understandability, relevance, reliability and comparability, all of which make accounting information useful to the users. All these characteristics enhance the integrity of information.

B. Future events, uncertainty and their influence on the integrity of information

- Other than events and transactions that are based on the past and the present, book entries are based on certain proposed future happenings.
- A future event has not taken place yet and because of the uncertainty about what is going to happen, in contrast to an event that is based on history and reality, the integrity of information may differ. The tool created to handle these uncertainties is the so-called 'book entry'. Future 'events' may be seen as artificial because they are made up, based on assumptions and personal judgements.
- Whether deferred taxation is viewed as an asset or as a liability, a book entry is used to portray this provision in the financial statements of a company. Because deferred taxation is based on some future conditions and realities, deferred taxation may influence the integrity of the information.
- A right or a claim is based on a future happening and therefore contingent assets may be brought about by book entries. The value of the contingency may also be based on the subjective opinion of management and therefore the integrity of such information may be influenced.
- Contingent liabilities are definitely created by book entries that are based on future happenings. If it is not possible to estimate the obligation, it may influence the integrity of information accordingly.

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- A provision represents a probable future cash outflow from the reporting company although the company does not know when or how much will be paid. A provision (book entry) based on uncertainty may not reflect the same integrity as information based on real transactions.
- Furthermore, because a contingency is a future happening, the provision for a contingency is created through the use of a book entry and may therefore influence the integrity of the company's financial information and subsequently any decisions based on such information.
- Assumptions, estimates and judgements are used in accrual accounting to introduce softness or uncertainty into accounting numbers. Whenever uncertainty, estimates or judgements are involved, it follows that the integrity of information is influenced by these and may be different to information based on reality. However, despite numerous criticisms, accrual accounting is useful for financial analysis but an accountant has to be aware of its shortcomings.

C. Earnings management and its effect on the integrity of information

- Thus, markets may be very unforgiving when a company is caught red-handed, and future trust is likely to be influenced by this. When future trust is influenced because of book entries, the integrity of the information in the financial statements is compromised.
- When income smoothing or creative accounting is put into practise by a company, it follows that the integrity of the information may differ from the integrity of the information created by real transactions.
- Earnings management takes on various forms but occurs, without fail, via book entries. A book entry is therefore a powerful tool with which a company may stretch accounting principles to their utmost limit and thereby compromise the integrity of any information based on such entries.

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- The dividing line between conservatism and manipulation of earnings appears to be rather thin. Both conservatism and the manipulation of earnings take place through the use of book entries and may therefore influence the integrity of the information provided in the financial statements.
- Under- or over-reporting of profits may influence the integrity of the information quite considerably. The information the investor will be using is influenced by book entries and is furthermore based on the subjective view of a manager.
- Managers use their discretion in income smoothing, hence communicating their private information in the process. The result is subjective information, leading to equally subjective decision-making.
- Applying a big bath may also affect the integrity of the resultant information.
- If the company uses book entries to show a different picture of their company to stakeholders, the integrity of the information created in this way may not be the same as the integrity of information resulting from real transactions.
- When a company decides to use book entries to reach certain strategic goals, some of the integrity of the information may be lost.
- When a company decides to revalue its assets, the bottom line of that company may be affected considerably. Book entries are used to revalue assets and increase or decrease the depreciation provision, which in turn decreases or increases the profit or loss, the dividend payout and the distributable reserve.

D. A new information perspective and book entries:

- The accountant being in the information business must therefore take note of the new realities which affect information. Since a book entry is neither a transaction nor a reality and represents intentional smoothing, aimed at presenting the business as stable as possible for reporting purposes. However, being stable in the new science is not

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considered a virtue.

- A real transaction differs from an artificial transaction which may affect the integrity of information. Relationships in a company may be affected by the information established in a company (e.g. a ratio is directly affected by the information contained in two variables – the numerator and the denominator) and the way an accountant (i.e. a human) perceives reality, has a direct effect on whether such an accountant may resort to the use or misuse of book entries, thereby affecting the integrity of information in a company.
- When making a prediction (forecast), an accountant makes primarily use of book entries, however, the quantum mechanics reveals that correct predictions are not possible. It follows that the integrity of information based on prediction may be impaired.

D. Internal funds

- Maintaining an internal fund for the replacement of fixed assets forces an accountant to keep track of such replacement costs from year to year, other than the alternative of losing track of such replacement costs over the years, only to be surprised by unbudgeted, escalating costs when the asset has to be replaced eventually.
- The use of a provision for internal funds had certain benefits since lost by modern accounting practices, for example, the replacement of a fixed asset might be funded more economically from an internal fund than an external fund.
- 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. (Refer to Chapter 7).

F. Depreciation and its effect on the integrity of information

- Depreciation has been an item of great controversy through the years and only came into
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force in 1943. A book entry that was so heavily criticised may indicate that the integrity of the information created by this book entry is not the same as the integrity of information created by real transactions.

G. Allocation and its influence on the integrity of information

- The allocation of common fixed costs mentioned above are viewed as book entries. Yamey called the allocation of fixed costs based on the wrong criteria, misinformation. When allocating fixed costs, an accountant needs to be very careful to use the correct allocation criteria. Using the wrong criteria may lead to information of a lesser integrity. An expense cannot be allocated to revenue that has little or no bearing on the expense when adhering to the matching principle. It is the experience of the author that in many companies expenses are allocated to various cost centres which did not benefit from the income which is matched with the expenses.

H. Book entries and their effect on capital

- Instead of watering the capital, items like goodwill writeoffs, depreciation and deferred taxation, all included in the accumulated profit or loss of a company, should not be part of the capital account.
- Therefore, if an accountant is uncertain about whether a debt is going to realise or not, it might be a good idea to omit it from the calculation of the owners capital – rather understate the capital and include the debt later, only after certainty regarding the realisation of the debt has been achieved.

I. Book entries and the funds statement

- Cash represents a real transaction and since a book entry does not represent cash, a book entry ought to be excluded from the funds statement, leading to the observation that information created by book entries may be of a different integrity than that of real

transactions (e.g. cash).

J. Book entries and their character

- If non-events are seen as purposive occurrences, and non-events are seen as book entries, it follows that the integrity of the information must be different to the integrity of the information generated by real transactions.
- The book entries or occurrences are not based on real transactions (cash transactions) but rather on the perception of an observer of a proposed happening. The effect is that these book entries are often based on a subjective observation made by the observer, possibly leading to subjective information on which further subjective decisions may be made by stakeholders.
- A book entry does not have any cash flow consequences, hence goodwill write-offs may be seen as book entries. If an asset cannot be touched and cannot be measured, it follows that the integrity of information created with the use of book entries may not be the same as information based on measurable and touchable assets. Again information content flowing from such book entries may influence managers to make incorrect (long-term) decisions.

K. Management and the use of book entries

- It is difficult to judge the relevance of the subjective information created by book entries because the purposes of these entries are unknown to the users of the financial statements. Book entries are used as a strategic tool by management; only management knows their purpose and this may influence the integrity of the information portrayed in the financial statements and subsequently any decisions based on such information.
- As soon as profits are manipulated, their integrity is in the balance, especially if the manipulation is based on personal intentions, incentive schemes or both.

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- When management's personal discretion results in the lowering of earnings volatility, the integrity of the information portrayed in the financial statements may be influenced.
- Book entries may be used or even misused by management depending on their personal integrity which, in turn, may influence the integrity of the information being reported and hence any future decisions based on such information.
- Managing people rather than objects can have a very positive effect on a company's bottom line. Sharing information in a company is crucial in today's marketplace and is one way of improving the different relationships in a company. However, if such shared information is influenced by book entries then the information may have a negative effect on the relationships within a company.
- Therefore, the outcome of a decision, strategic goal, etc. is often determined by the frame of reference and the mind set of the observer which may be very subjective and in turn may influence the integrity of information.

L. Personal judgements, perceptions and information integrity

- Referring back to the credit sale, book entries are used to make provision for doubtful debts, which in turn may influence the integrity of the information portrayed in the financial statements.
- Matching is based on a person's (subjective) perception and may therefore, influence the integrity of information supplied in the financial statements.
- Deciding which costs should be spread over a period and which not, has a very important effect on the information supplied in the balance sheet because it is based on the personal judgements of management. Since the balance sheet is a mix of what happened and what is going to happen, these personal judgements also influence the integrity of the information supplied.
- Whenever there are constraints on interpretation, it follows that the integrity of the underlying information may be impaired.

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- If a provision is seen as speculation about what might happen, it is clear that the integrity of information created by book entries might not be the same as the integrity of information created by transactions that are based on facts.

M. Book entries and their influence on the financial statements

- The profit or loss calculated in the income statement is little more than a book entry, because so many book entries are allocated to the income statement based on the matching assumption.
- 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.
- When depreciation is provided on the basis of a calculation of the revaluation of assets, the profit or loss before tax as well as after tax is influenced, together with retained earnings and dividends. This illustrates how many items in the financial statements may be influenced by book entries.

N. Real transactions, artificial transactions and integrity of information

- The combination of real and artificial transactions may have a big impact on the integrity of the information created by the outcome of a ratio. As with all information on which important decisions are based, users of ratios need to know that the value of any such ratio is beyond suspicion.
- 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.

O. Lack of knowledge where book entries are concerned

- 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. 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.
- 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.

P. Book entries and ratios

- When the long-term-debt-to-total-equity ratio was adjusted to compensate for the effect of book entries, more than 50% of the 30 companies had a deviation of between 34% and 66% in the ratio results.
- The adjustment to the gearing ratio resulted in a deviation of between 0% and 66% in 24 of the 30 companies. These results do indicate a change in the integrity of the information.

Q. Integrity of information according to the respondents to the questionnaire

- The responses to the questionnaire also indicated that the integrity of information is affected by book entries. For example, some respondent emphasised the hypothesis: "There is no question that book entries are utilised to manipulate information to the detriment of users".
- Also, "Investors seem to prefer steady growth in earnings, rather than ups and downs".
- Lastly "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".

- There are some respondents that emphasise the hypothesis of this research, namely, that the integrity of information created by real transactions is different to the integrity of information created by book entries.

From the above summary of the main findings it, therefore, follows that the hypothesis is strongly supported by both the responses to the questionnaire and the analytical research.

8.5 Recommendation

In the light of the results obtained in this work, it is recommended that a new classification system for book entries be developed. Book entries influence the integrity of financial information to such an extent that their effect may need to be indicated much clearer in the financial statements of a company to enable decision makers to make the correct decisions based on high-integrity information.

The audit profession need to take note of the substantial effect that book entries have on the financial statements and they will need to adjust their auditing techniques and principles.