Exploring the influences and constraints on creative accounting in the United Kingdom

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ABSTRACT
Allegations of creative accounting by management of listed corporations in the UK do not abate. To the extent that these practices distort the underlying reported financial performance of firms, they conflict with the basic aims of accounting regulation – to provide consistent and comparable financial information to users. Studies have shown that accounting choices are influenced by a range of contracting, financing and operational factors. However, we still know little about what constraints exist against the practice of creative accounting and how effective these are. Issues such as the extent to which the press and analysts are successful in restraining creative accounting, and the role the ‘true and fair view’ principle and auditors play in the prevention of such practices still remain unresolved. This article explores these themes by examining the accounting practices of two UK companies which issued a creative financing instrument. Using a combination of interview, documentary, and financial statement information, the analysis shows that management took advantage of gaps in accounting standards to present a biased picture of financial performance. Auditors did not appear to restrain such practices, and the true and fair view principle, rather than unifying accounting practice, appears to tolerate a range of interpretations. Adverse media publicity appears to be a successful deterrent in the medium term, but since the press are not regulators, their reporting is not necessarily consistent or predictable. UK analysts at the time did not evaluate accounting practices in any significant detail, and thus this potential restraint was not effective. Overall, the influences and constraints on creative accounting are illuminated in this study in a way which provides new insights into our understanding of financial reporting.

INTRODUCTION
In recent years, there has been a significant increase in allegations about the practice of creative accounting by listed corporations. Creative accounting can be understood as the process by which management take advantage of gaps or ambiguities in accounting standards to present a biased picture of financial performance. The press and analysts are not always successful in restraining such practices, and the true and fair view principle appears to tolerate a range of interpretations. Adverse media publicity can be a deterrent in the medium term, but since the press are not regulators, their reporting is not necessarily consistent or predictable. UK analysts at the time did not evaluate accounting practices in any significant detail, and thus this potential restraint was not effective. Overall, the influences and constraints on creative accounting are illuminated in this study in a way which provides new insights into our understanding of financial reporting.
financial performance. It does not breach the letter of the law or rules, but may breach its spirit. Griffiths (1986) and Smith (1992) have documented such practices by UK companies and, much earlier, Briloff’s work (e.g. Briloff, 1972) has documented this practice in North America. To the extent that this practice distorts the underlying financial performance of a firm and makes it difficult for investors and analysts to compare between different companies, it conflicts with the basic aims of accounting regulation. It makes the exercise of standard setting appear redundant, and rather than creating a level playing field, provides an unfair advantage to those companies that are able to successfully practice creative accounting.

The primary focus of the literature thus far has been to try to explain variations in accounting policy choices, without necessarily analysing the constraints on and effectiveness of creative accounting per se. Earlier work tested the extent to which contracting factors such as bonus contracts and debt covenants impact actual choices (Watts and Zimmerman, 1986). More recent empirical evidence suggests that a combination of factors simultaneously impact accounting choices (Buchan et al., 1992; Whittred and Zimmer, 1994; Pourciau, 1993; Mian and Smith, 1990; McInnes, 1990). Thus we do know that accounting policy choices are influenced by a range of operating, financing and contracting factors. What we do not know is why or for how long it is that creative accounting schemes appear to go undetected. If analysts are able to ‘see through’ creative accounting devices as is suggested in the efficient markets literature, why is it that companies continue to practice them? To what extent are the constraints on creative accounting such as the true and fair view and audit qualification and adverse media comment effective?

In the context of European harmonization, the British have favoured (and pushed into European law) the true and fair view (TFV) principle as the best defence against the predominance of the legal (continental) approach. One of the central reasons behind this was to enable the reporting of the commercial substance of business transactions, as opposed to their legal form (McBarnet and Whelan, 1991). Hence this was seen as a defence against creative accounting practices, which by definition aim to exploit gaps or ambiguities in specific accounting rules or standards. This paper will examine the extent to which this principle influenced the accounting choices made by the firms examined.

As most of the accounting policy choice studies have examined specific hypotheses over a large sample, they have been unable to capture the breadth of data sources and exploratory analysis that can be offered by focusing on fewer companies. For example, management would need to have access to the means of creative accounting and the possibility of any adverse publicity this may generate would potentially constrain their behaviour. Motivations for practising creativity need to be compared with constraints and final outcomes if we are to understand how creative accounting manifests itself
and succeeds in escaping publicity or regulatory sanction. In addition to examining accounting policy choices, we would need to focus on the work and commentary of external parties such as the press, auditors and analysts to understand their relative influence in the process.

The predominant approach in the literature has the strength of providing high external validity, as large sample sizes have a greater potential for generalizability. However, considering that the question of investigating the motivation for accounting policy choices is crucial to research in financial reporting, the conventional approach leaves a significant gap. From purely examining publicly available information sources, and avoiding interviews or discussions with management, it is very difficult to prove causality. All we can observe are consistent correlations between various variables. With a more eclectic approach which sacrifices high external validity, but examines processes and outcomes in greater depth, the possibility of enriching our theoretical knowledge and dimensions of causality is significantly enhanced. This difference in methodological approach is one of the key contributions of this study.

As Hammersley and Atkinson (1983) have explained:

\[
\ldots\text{the depiction of perspectives and activities in a setting allows one to begin to develop theory in a way that provides much more evidence of the plausibility of different lines of analysis than is available to the ‘armchair theorist’, or even the survey researcher or experimentalist.} \ldots\text{As a result, ideas can be quickly tried out and, if promising, followed up. In this way, ethnography (case study research) allows theory development to be pursued in a highly effective and economical manner.}
\]

Thus such an approach helps us provide new insights, enabling us to explore the influences and constraints on creative accounting and better understand and theorize the accounting policy choice process. It provides a demonstration of the possibility of a deeper enquiry into company and accountant behaviour.

This study explores ways in which various factors interact and influence creative accounting practices. To the author’s knowledge, none of the studies in the literature evaluate press comments, analyst reports, the true and fair view principle, and the role of auditors in accounting policy choice, but these are shown to have the ability to constrain opportunistic management. There seems to be a time lag between initiation and public detection of a creative accounting scheme, and a definite lag in regulatory response. This provides companies with time to cover up any creativity through healthy underlying performance in future years. The case studies present an understanding of accounting policy making in the UK financial reporting environment, suggesting that creative accounting can be restrained by better interpretation of financial statements through analysis and research and active publicity of such practices. Although individual standards and accounting choices are important, regulators also need to examine the whole portfolio of accounting
choices adopted by firms if they are to be successful in restraining such practices. Owing to a framework of rules and concepts, there is often a grey area where there are no specific standards, and concepts need to be interpreted to provide policy guidance. It is in these areas that auditor bias can help companies implement their preferred accounting choices, even though the accounting principles may suggest otherwise. Auditor bias can potentially be reduced if there is an active enforcement of technical releases and UITF pronouncements. The combination of weak external analysis and auditor bias increases the likelihood of success in creative accounting for firms who wish to practice it.

**RESEARCH METHOD**

One particular transaction which had hitherto not attracted any specific accounting regulation was selected as a focus for the analysis. The security chosen was the premium put convertible, since during the period of the study (1987–90), it was an innovative financing instrument which attracted a lot of interest from companies seeking finance (McInnes *et al.*, 1991; Shah, 1996). Smith (1992) devotes Chapter 13 of his influential book on UK creative accounting to such instruments. During the study period, there were no specific accounting rules which standardized the treatment of the supplemental interest (see later) nor helped guide the debt/equity classification controversy. This lack of a specific accounting rule provided companies with a relatively wide range of accounting choices (as compared to transactions which have specific accounting standards), thus providing a suitable arena for studying the accounting choice process. At the same time, the whole portfolio of accounting choices adopted by the firms was analysed to obtain a more complete understanding of the accounting choice process.

Of a total of 24 UK issuers of premium put convertibles, this paper presents detailed case studies of two companies, with a few supporting observations from three other companies to illustrate specific features. The two principal companies are Burton Group plc and Tesco plc, both of which are in the retailing sector – one in clothes and the other in foods. The three supplementary companies are Next plc, Attwoods plc and United Biscuits plc. A wide range and quantity of data sources were used for the study: prospectuses, annual reports, press reports, analyst reports, and interviews. In total, some 20 annual reports, 100 press cuttings and 79 analyst reports were examined for this study. This is complemented by interviews with analysts, management and auditors where appropriate and feasible.

An inductive approach was used in the analysis, trying to reason from particular facts to general ideas. For example, when studying the accounting choice for the convertible, the ‘Management Discussion and Analysis’ narrative in the annual reports provided clues as to the motives underlying the financing method choice. Both Burton and Tesco boasted here about their
grip on balance sheet gearing and favourable earnings per share (EPS) performance. From the notes to the accounts, specific data items were obtained from different pages and pieced together like a jigsaw – the amount of the interest charge relating to the convertibles; the actual and contingent liability; and details of the terms of the convertible security, and the accounting policy adopted for the convertible. This revealed that the accounting policy was not always explained in the same place with other accounting policies and neither was the contingent liability quantified and disclosed in the usual note. This process revealed that in practice, the detection of creative accounting is difficult, requiring time, knowledge of accounting standards and GAAP, and a comparison of annual report information with alternative sources.

As an example, while compiling and analysing the evidence on Burton, it became apparent that the creative accounting practices were not constrained to one instrument – the convertible bond – but to a whole range of operating and financing techniques, having a consistent underlying aim. The wording and location of the disclosures appeared to be actively managed, but careful examination and cross-checking of the financial information revealed the underlying facts. The lack of any detailed evaluation of the financial statements by analysts was a revelation, helping to explain why it was that there was a delay in the public reaction against such creative accounting choices. This phenomenon suggests that where management genuinely believe their underlying performance will improve, creative accounting may be attractive in the short term since there is a usual time lag in any regulatory reactions, and better future performance may overshadow the past creativity.

**PREMIUM PUT CONVERTIBLES: TERMS AND ACCOUNTING CHOICES**

A premium put convertible is the combination of a bond and a dual option held by the bondholder – one to convert the securities into the underlying shares of the issuer (call option) and another to force redemption if the underlying share price does not rise adequately (put option). The ‘premium put’ feature is an addition to conventional convertibles to compensate for the fact that the coupon of the security is lower than that for conventional convertibles. Thus, in order to compensate bondholders for the lower coupon, they are given a put option which can be exercised at the end of the first five years to help recoup the equivalent market return (hereafter described as the supplemental interest). Details of the Burton premium put convertible are given below by way of example. In January 1987, Burton made a new issue of £110 million 4.75% convertible bonds due 2001. The terms of the bonds are described in detail in the prospectus and can be summarized as follows:
(i) The bonds bear interest at 4.75% per annum. Lenders can convert the bonds into ordinary shares at a premium of 27% to the price prevailing at the time the bonds were issued.

(ii) In five years’ time, the bondholders can force the issuer to redeem the securities at a price of 136.5% of the principal amount lent, the bulk of the premium comprising the market interest return which would have been payable if the share price had not underperformed (effective annual interest of 9.98% p.a.). Thus there is an anticipation of a substantial improvement in the share price which will compensate bondholders for the lower coupon interest earned in the earlier years.

Table 1 summarizes the terms of the Burton and Tesco convertible, and their accounting policy choices.

The central accounting policy choice surrounding premium put convertibles relates to the treatment of the supplemental interest (difference between the coupon interest and the effective interest rate if the put option is exercised). Should issuers of such securities accrue the extra interest from the first year or alternatively, should the need for accrual depend on the performance of the underlying share and its likelihood of exceeding the promised conversion price? Under both the accruals and the prudence

Table 1 Details of the convertible securities issued by Burton and Tesco (Source: Issue Prospectus)

<table>
<thead>
<tr>
<th></th>
<th>Burton</th>
<th>Tesco</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of issue</td>
<td>January 1987</td>
<td>March 1987</td>
</tr>
<tr>
<td>Coupon</td>
<td>4.75%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Premium put option return*</td>
<td>36.5%</td>
<td>27.6%</td>
</tr>
<tr>
<td>Effective annual interest rate</td>
<td>9.98%</td>
<td>8.76%</td>
</tr>
<tr>
<td>Accounting policy</td>
<td>Accrue interest at 4.75% p.a., ignoring supplemental interest. Policy changed to full accrual in November 1990</td>
<td>Accrue interest at 4% p.a. Policy changed to full accrual (including supplemental interest) in April 1989</td>
</tr>
<tr>
<td>Annual reduction in expense as a result of non-accrual of supplemental interest</td>
<td>£5 750 000</td>
<td>£5 470 000</td>
</tr>
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* This is the overall supplemental interest over the five-year period which would be payable if the share prices do not rise sufficiently in order to make conversion attractive.
concepts outlined in the Companies Act 1985 (Schedule 4), the answer to the former is yes – it would be prudent to provide for the extra interest as the possibility of early redemption can never be ruled out. At the same time, interest expense needs to be matched with income generated from the finance raised, and thus the accruals concept would require amortization of supplemental interest. Under the consistency principle, since the convertibles are initially classified as debt until converted, non-accrual of supplemental interest presumes that the instruments will be converted, which would imply equity classification – making the accounting treatment inconsistent. From the true and fair view principle, the substance of these instruments is that they are debt until converted, and hence supplemental interest should be accrued to recognize this. In addition, since share prices are volatile, to predict the likelihood of the share price exceeding the conversion price accurately is difficult in practice.

In November 1987, the ICAEW issued a technical release TR677 ‘Accounting for Complex Capital Issues’ (published in Accountancy, January 1988) which dealt with premium put convertibles. TR677 favoured accrual of supplemental interest ‘unless there are good economic reasons for taking another approach’, without specifying these reasons. It remained consistent with the principles laid down in the Companies Act 1985. Although a technical release does not carry the same force as an accounting standard, it acts as an important indicator of GAAP – Generally Accepted Accounting Principles. Compliance with GAAP is regarded as an important aspect of the meaning of the TFV principle, suggesting that companies which do not accrue supplemental interest may be breaking the law (McGee, 1991). Hence companies and auditors are obliged to take TR677 into account in determining accounting choices. TR677 did not consider or elaborate upon what it considered to be ‘good economic reasons’, but a favourable performance in the share price may suggest a greater likelihood of conversion rather than redemption, although in practice, the uncertainties surrounding stock price movements are significant. The chart (Figure 1) illustrates the timing of the technical release and accounting policy changes for both Burton and Tesco.

It should be noted that the first Urgent Issues Task Force statement issued by the newly created Accounting Standards Board in July 1991 related specifically to the treatment of supplemental interest for premium put convertibles (Accounting Standards Board, 1991). This required amortization of supplemental interest irrespective of share price performance, arguing in particular that if the bond is converted, the effective consideration of the shares issued is equal to the proceeds of redemption foregone by the bondholders, thus requiring amortization. This was finally incorporated into a new accounting standard on convertibles, FRS4, which was issued in 1993 (Accounting Standards Board, 1993).
Had the supplemental interest been accrued, Burton would have needed to expense an extra 5.23% p.a. – an extra £5.75m charge against profits – a material amount under any criteria (e.g. it would represent 6% of 1986 net profit). Considering the structure of the convertible, the only likely economic reason justifying non-accrual (considering accounting guidance prevailing at the time) would be a realistic optimism about the future performance of the share price (which would make early exercise of the put option unlikely). This belief can be justified in the early years if the share price is performing well and is close to the conversion levels. However, considering the size of the conversion premium, this is unlikely to happen in the early years. Hence in most circumstances, the prudence concept and TR677 would require the accrual of supplemental interest.

In 1987 and 1988, both Burton and Tesco did not accrue the supplemental interest, despite the fact that both companies’ share prices had been depressed by the global stock market crash of October 1987. Burton’s share price did not recover whereas Tesco’s price did recover in 1989. Surprisingly, it was in that year that Tesco decided to change its accounting policy and accrue the supplemental interest. When a director of Tesco was interviewed about the choice he explained that the accounting policy change was adopted in order to comply with best practice (TR677). However, TR677 was issued eighteen months prior to the accounting policy change. ‘There was a sea change in opinion on the treatment of the convertible in 1989’, the Tesco
director explained. In contrast, however, Burton avoided accrual until November 1990 when underlying performance deteriorated significantly and there was a reshuffle in management. Thus TR677 was initially circumvented by both companies. This evidence suggests that the weakness in the regulatory environment prevailing at the time (in terms of the monitoring and enforcement of technical releases) allowed companies to continue their preferred choices.

Both Burton and Tesco had a rising trend in earnings per share and a declining trend in leverage between 1986 and 1990. Both companies used off-balance sheet finance schemes which had the effect of reducing gearing. Burton set up a ‘controlled non-subsidiary’ through which it raised significant new loans and this helped it to disguise the true levels of its debt. Both companies used sale and leasebacks to reclassify finance leases as operating leases, and Tesco also used a ‘deadlock’ joint venture scheme to avoid consolidation of its loans. In 1990, there was a major management reshuffle at Burton and alteration of accounting policies, including a change to accrual of supplemental interest.

A detailed review of all the other accounting policies of Burton and Tesco showed that their policies were biased towards showing higher EPS and hence were relatively less prudent. For example, interest incurred on borrowings to finance major capital projects and property developments is capitalized. In 1989, Burton recognized a pensions surplus as a credit in the profit and loss account ‘from substantially complete actuarial valuations’ (1989 annual report, p. 28). This improved its reported profits. By 1991 Tesco had capitalized £63m worth of accumulated interest (Burton, £25m) – a substantial amount.

We will now examine the key motivations and constraints of creative accounting.

CREATIVE ACCOUNTING: MOTIVATIONS AND CONSTRAINTS

Key motivations

Contracts

In the United Kingdom, access to details of management bonus contracts and debt covenants is difficult, and was denied in the case of Burton. However, both companies had significant earnings-related management bonus schemes during the period. In the case of Tesco, the fact that the accounting policy was reversed much earlier suggests that bonus contracts may not have an overriding impact on managerial accounting choices. Thus although Positive Accounting Theory suggests that earnings-related bonus contracts play an important influence on management choices, it appears that some managers may be reluctant to pursue this all the way, if other factors (such as media
publicity) make the choice controversial. There seems to be a trade-off between different motivations and constraints. In the case of Burton, the 1988 annual report (note 22) suggests that bonuses vest after a four-year period of earnings growth. This may have impacted the policy of delaying accrual of supplemental interest as much as possible.

Closeness to debt covenants can be estimated using a conventional gearing ratio such as Borrowings/Shareholders Funds (Duke and Hunt, 1990). Ratio analysis revealed that both Burton and Tesco exhibited an increase in gearing during the period (1986–1989). This increase was further exacerbated if off-balance sheet borrowings were taken into account. For example, the gearing ratios in the case of Burton were as shown in Table 2.

In contrast, Tesco had a much lower average gearing ratio of 23% (before adjustment) and 27% (after adjusting for off-balance sheet finance). Thus Burton had significantly high gearing levels (after adjusting for off-balance sheet finance), suggesting a greater likelihood of closeness to covenants than Tesco. This (Tesco) evidence is further corroborated by the interview with the Tesco director, who said that the debt covenants were not onerous during the period.5

Table 2 Gearing ratio for Burton Group before and after taking account of off-balance sheet finance (Source: Financial Statements)

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<tr>
<td>Before (%)</td>
<td>95</td>
<td>67</td>
<td>39</td>
<td>27</td>
</tr>
<tr>
<td>After (%)</td>
<td>145</td>
<td>169</td>
<td>132</td>
<td>110</td>
</tr>
</tbody>
</table>

Performance indicators

Where management have some freedom in making accounting policy choices, it is likely that their decisions will be influenced by the performance criteria by which they are assessed. Two of the most important performance criteria used to evaluate UK companies relate to profitability and indebtedness: the Earnings Per Share and the Gearing Ratio (Smith, 1992: Chapter 17). These are also the most common indicators cited in press reports (see later). The Tesco director interviewed admitted that these performance ratios are important to the firm and its public perception, although they are not an overriding concern. A premium put option provides the dual advantage of improving EPS prior to conversion (if supplemental interest is not accrued), and reducing gearing after conversion. Attwoods went as far as asking analysts to evaluate and calculate their gearing in a certain way. In both the 1989 and 1990 annual reports, the financial review included this statement (1989 annual report, p. 25):
In assessing Attwoods’ debt capacity, it is considered more appropriate to use gearing on shareholders funds before deducting goodwill and to look at this in conjunction with interest cover.

If shareholders funds are taken after goodwill is deducted, the shareholders funds would shrink, and gearing would therefore look very high – hence analysts are guided on the approach preferred by management. Hence when firms are faced with a choice of accounting policy, we would expect management to favour that policy which presents the above indicators in a favourable light.

**Constraints on management discretion**

**Media**

One of the most effective methods of restraining creative accounting is through generating publicity over such abuses (Gallhofer and Haslam, 1993). Quoted companies are likely to be concerned about their public image, and hence to shy away from adverse publicity on aggressive accounting choices. In order to examine the importance of this factor, the reports of two of the most influential users of financial statements, the financial press and investment analysts, were analysed.

At the time of issue of these convertibles, there was no adverse comment on the terms and accounting implications in the financial press. The first critical reports appeared in 1988 long after the stock market crash of October 1987. Burton’s non-accrual of supplemental interest in 1988 was highlighted by the media. Instead of changing its accounting policy due to a declining share price, Burton introduced an additional rolling put option which extended the put option by another five years, thereby increasing the likelihood of conversion rather than redemption. However, in reality, bondholders would exercise the put option at the first opportunity if the share price failed to perform, as they would otherwise be taking on more risk without any additional return (Macdonald and Selbie, 1988). The *Financial Times* of 18 November 1988 talked about the change of terms and its non-impact on accounting policy without being critical:

Burton showed other issuers of convertible bonds with put options a way to avoid providing for the interest which would be payable if the put is exercised. It has changed the terms of its £110m convertible issue to make early redemption at the holder’s choice less likely.

... Some other companies which have such bonds outstanding have provided for the interest which may become due – such as Next, Ratners, Storehouse and Argyll.

From the above comment, there is a hint that Burton’s accounting policy is out of line, but it is not stated explicitly. The article explains clearly that the rolling put is a device for avoiding any provision for supplemental interest.
By 1989, media suspicions on Burton’s creative accounting became very strong and the *Investors Chronicle* (24/11/89) stated:

> It is clear to everybody by now that playing around with the figures endears you to no-one in the City. At best, it smacks of being too clever for your own good, at worst it suggests that you have something to hide.

Profits did not provide for any extra interest which may become payable on Burton’s convertible bond. The company reported year-end debt of £346 million, 47% of shareholders funds. Adding the debt in the credit card business and off-balance sheet property debt could take this as high as 110%, but Burton was at pains to stress that this kind of accounting is purely a ‘cosmetic’ matter.

This and other press reports (*Independent*, 7 July 1989; *Financial Times*, 18 July 1989) may have played a critical factor in the 1990 management reshuffle at Burton and a change in accounting policy to accrual of supplemental interest and consolidation of off-balance sheet finance schemes. Pourciau (1993) also found that significant accounting changes were made as a result of major reshuffles, and departing executives adopted those choices which decreased earnings in their last year of tenure. However, the link between adverse press comments, accounting policies and executive changes has not been explored in the literature, and the evidence here suggests that the media play an influential role, although this cannot be precisely established without further research.

Tesco also attracted press comment on the non-accrual of supplemental interest. When the interim results were released in September 1988, the *Financial Times*, *Times* and *Daily Telegraph* all commented on the accounting policy for the convertible by noting that Tesco had not yet provided for the supplemental interest. For example, the *Financial Times* (20/9/88) stated:

> Tesco has not yet decided whether to follow Next in providing for the interest which would be due if holders of the convertible Eurobond demanded early redemption. An annual sum of between £6m and £7m would be necessary.

However, Tesco finally changed its policy and provided for the supplemental interest in the 1989 annual results, despite the fact that at that time, there was a significant improvement in the share price. Unlike Burton, however, Tesco did not attract any adverse comment on its overall portfolio of accounting policy choices, even though, as we examined earlier, it did have a number of creative accounting schemes. The Tesco director explained when interviewed that media comments are noted but may not always directly influence accounting choices. In this case, the change was adopted to comply with best practice prevailing at the time. The *Financial Times*, *Independent* and *Investors Chronicle* all noted the change of policy once it was announced (13/4/89). Thus, even for Tesco, the press appears to have an important influence on its change of accounting policy, although the director was unwilling to admit the degree of importance the company gives to it.

Thus media suspicions were not expressed until November 1989, two and a half years after the securities were first issued. When criticisms against
accounting policies were expressed, they appeared to have an impact on the choices which were adopted. This suggests that the media does have an important power in influencing accounting choices in controversial areas, but as it is not a regulator, it only has an influence when it notices and reports abuses. A former editor of the Financial Times, Sir Geoffrey Owen, stated in an interview\(^6\) that the paper’s main aim was to report the facts and annual reports were only critically appraised in certain sections of the paper. ‘These analysis sections are often dictated by space limitations and depend on the major news stories for the day’, he explained.

Analysis of the press comments for all the five companies (Table 3) suggested that the extent of detailed media analysis and commentary on accounting choices had some correlation with the share price performance. Where share prices had declined for a significant period – one and a half years in the case of Burton – the press reports tended to probe the accounting numbers more closely than before. Similarly, Next plc had favourable reports in the Financial Times until April 1989, when the first accusations of creative accounting were made (Financial Times, 12/4/89), after a sustained period of

<table>
<thead>
<tr>
<th>Company (Audit firm)</th>
<th>Share price performance prior to adverse press comment (if any)</th>
<th>Date of first reported media suspicion of creative accounting</th>
<th>Accounting and other significant changes thereafter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tesco (Price Waterhouse)</td>
<td>Upward</td>
<td>No significant media concern. Financial Times queried accounting policy re convertible in September 1988</td>
<td>Change of accounting policy re convertible in April 1989. No other significant changes to accounting policy or management</td>
</tr>
<tr>
<td>Next (Ernst &amp; Young)</td>
<td>Downward during 1987–90</td>
<td>April 1989</td>
<td>Boardroom reshuffle and change of accounting policies (including convertible)</td>
</tr>
<tr>
<td>United Biscuits (Ernst &amp; Young)</td>
<td>Volatile upward during 1987–90</td>
<td>No significant adverse comments on creative accounting in the media</td>
<td>No change in accounting policy</td>
</tr>
<tr>
<td>Attwoods (BDO Binder Hamlyn)</td>
<td>Volatile upward during 1987–90</td>
<td>None during period</td>
<td>No change in accounting policies</td>
</tr>
</tbody>
</table>

Table 3 The links between press comments and accounting choices for sample companies between 1987 and 1990 (Source: Datastream and McCarthy’s Press Cuttings)
declining share price. From the above, it is possible that media reporting is prompted by share price performance and where the share price is rising, the analysis is not directed towards identifying any creative accounting. This evidence suggests that the use of creative accounting practices is directly correlated to share price performance, a hypothesis which could be investigated in future research. Analysis of the three big 1980s British corporate collapses – Coloroll, British & Commonwealth and Polly Peck – by Smith (1992) shows that although there was a high degree of creative accounting, this was not seriously probed and commented upon until after the share price started to decline.

**Analysts**

Of all the commentators on a company, we would expect the analysts to conduct a detailed analysis of the company and its financial statements and spot any inconsistencies (Arnold and Moizer, 1984; Day, 1986). In fact, most of the press reports examined appear to rely on analysts for this detailed research (Table 4).

However, in this study (79 reports were examined covering four companies), the evidence showed that the analysts did not conduct any serious analytical research. Analyst reports on Burton were examined between 1986 and 1990. Typically, these reports tend to be two pages long, and from the number of words devoted to accounting issues, it is clear that very little attention was paid to the accounting details at the time. Generally, the reports were brief and descriptive (as opposed to analytical), and there was an emphasis on making an overall buy/hold/sell recommendation. This approach encourages short-term-oriented analysis, as opposed to looking at the investment as part of a larger portfolio or longer-term investment horizons. Gearing calculations, when made, did not adjust for the off-balance sheet finance. There was rarely any detailed commentary on any specific aspect of accounting policy. Barclays de Zoete Wedd (BZW) made a consistent buy recommendation even after the problems emerged in 1989 and 1990. The

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of analyst reports examined for period 1986–90</th>
<th>Number of different analyst firms whose reports were analysed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burton</td>
<td>18</td>
<td>4</td>
</tr>
<tr>
<td>Tesco</td>
<td>23</td>
<td>4</td>
</tr>
<tr>
<td>Next</td>
<td>16</td>
<td>4</td>
</tr>
<tr>
<td>United Biscuits</td>
<td>22</td>
<td>5</td>
</tr>
<tr>
<td>Attwoods</td>
<td>No analyst reports available</td>
<td></td>
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</table>
BZW statements appear to be a ‘mouthpiece’ for the company; e.g. the 17/11/89 report stated:

Net debt had reached £275m by the year-end (gearing of 44%). However, cash flow should not be outspent by much. With a majority of debt on a fixed low coupon basis, interest charges should not rise very far.

A senior investment analyst in the City was interviewed about the skills and resources of UK analysts in analysing financial statements. He explained:

Analysts are generally weak in their ability to analyse accounting information. Very few firms have any formal training courses for analysts.

When asked about analyst bias, he replied:

If the analyst firm was also the main stockbroker to the company, they would never make a sell recommendation. Hence there is some bias in analyst reports.

This evidence is also supported by other work on the quality of UK analyst research (see Taylor, 1990). Day (1986) found that none of the analysts interviewed in her UK study had any professional accounting qualifications. It may also not be a mere coincidence that BZW was Burton’s main stockbroker.

From the above, we witness a low degree of external monitoring of company performance, particularly on detailed aspects such as accounting policies. Where the skills for such evaluation are lacking and the independence of analysts is at times questionable, there is little external restraint on accounting choices. This seems to have been a major factor which encouraged creative accounting practices in the UK – the lack of any real public deterrence. The publication of Smith (1992) and the publicity it generated revived the focus on detailed examination of financial statements. Hence although the media and analysts may not have a direct contractual relationship with a company, they can have an important impact on its accounting choices. As we saw in the case of Burton and Tesco, when the press discussed the accounting policy relating to the premium put convertible, there was a noticeable impact on the accounting choice (although direct correlation cannot be proven). The interview evidence also suggests that management do take these press reports seriously.

**Auditors**

Where there is a lack of clear guidance on accounting policy choices, the auditors have to exercise professional judgement in the interpretation of the regulations and help the company to show a ‘TFV’. When asked how accounting policy choice decisions are taken, the Group Chief Accountant of United Biscuits explained (interview, March 1995):

The Finance Director takes the final decision, but earlier development is done by the Chief Accountant, working closely with guidance from auditors. This is an ongoing process, not necessarily left to the year-end.
The above evidence demonstrates that, for a while, both Burton and Tesco adopted accounting policies which did not implement GAAP as suggested in a technical release. Both companies were audited by the same Big Six firm, which permitted Burton’s non-accrual in 1988 and 1989 and Tesco’s reversal of accounting policy in 1989. The auditors did not qualify their audit reports. A Tesco director explained when interviewed that the auditors supported their accounting policy choices throughout.

For all issuers of premium put convertibles, there was a surprising variety in the accounting policies sanctioned by the audit firms. For example, one Big Six firm (Ernst & Young) sanctioned the range of accounting choices shown in Table 5.

From Table 5 we get an idea of the degree to which auditors were inconsistent in their sanctioning of accounting policy choices. ASDA and London International Group changed their accounting policies in 1991, while Next and Thorn EMI changed their accounting policies much earlier (in 1989). Burton’s auditors were the Leeds office of another Big Six firm (Price Waterhouse) and it is therefore likely that their fees were an important source of income for the office (annual audit fee – excluding consulting fees – reported for 1988 was £700 000). The main point here is that auditors can play an important role in influencing accounting policy choices in subjective areas but they did not appear to exercise much influence against corporate management in this area. A further technical release TR827 (Institute of Chartered Accountants in England and Wales, 1991) was issued in February 1991, this time requiring all issuers of premium put convertibles to accrue the supplemental interest, thus taking a stricter (and less ambiguous) line than TR677. An audit partner in a Big Six firm who was involved in the revision of TR677 commented when interviewed:

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Share price trend during 1987–90</th>
<th>Year of issue</th>
<th>Accounting policy re supplemental interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASDA Group</td>
<td>Downward</td>
<td>1987</td>
<td>Accrual in 1991</td>
</tr>
<tr>
<td>Albert Fisher</td>
<td>Upward</td>
<td>1989</td>
<td>No accrual</td>
</tr>
<tr>
<td>Ladbroke Group</td>
<td>Flat</td>
<td>1989</td>
<td>No accrual</td>
</tr>
<tr>
<td>Next</td>
<td>Downward</td>
<td>1987</td>
<td>Accrual in 1989</td>
</tr>
<tr>
<td>Thorn EMI</td>
<td>Upward</td>
<td>1989</td>
<td>Accrual made by reserve transfer in 1989. No impact on reported profits</td>
</tr>
<tr>
<td>United Biscuits</td>
<td>Upward</td>
<td>1988</td>
<td>No accrual</td>
</tr>
</tbody>
</table>

Table 5 Accounting policy choices sanctioned by the same Big Six firm (Ernst & Young) for different clients issuing premium put convertibles (Source: Annual Reports and Datastream)
There was wide variety of accounting and disclosure treatments. TR677 was a technical release and not a standard and was not implemented by many issuers of premium put convertibles. Commercial pressures have forced many audit partners to compromise on technical accounting issues, and the lack of consistency in accounting policies sanctioned by other members of the profession makes it more difficult for the conscientious auditors to take a hard line.

Hence the inconsistencies among members and firms belonging to the same profession is an important factor which influences accounting policy choices in practice. The absence of a clear conceptual framework coupled with the unwillingness of certain auditors to take a stricter approach on accounting choices helps the creative accounting process.

There was some evidence to suggest that auditors approve these accounting choices in advance of the decision to adopt a particular financing method, where such choices are intertwined with financial instrument selection. For example, in the case of United Biscuits, the following statement was made in an article in *The Banker* at the time the convertible was issued (*The Banker*, May 1988, p. 51): ‘The company’s auditors ruled that United Biscuits need not amortise the put premium in its accounts, whereas other issuers of convertibles have been unable to avoid making such a provision.’ Advance consultation with auditors helps create a degree of certainty about accounting choices for management, and at the same time shows that accounting considerations are important in financing decisions.

**CONCLUSIONS**

The practice of creative accounting makes comparison of the performance of different companies both difficult and costly, and goes against the objectives of harmonization of accounting policies and practices. The research conducted in this article explored the environment of creative accounting in the UK, focusing on the motivations and constraints on such practices. The findings show that the particular mix of the UK financial reporting environment (where accounting numbers are important, management are powerful, and auditors, press and analysts were weak and inconsistent in restraining such practices) explains why they thrived in the 1980s.

Creative accounting in the United Kingdom is influenced by two key motivators. Of primary importance are stakeholder contracts and performance indicators, which motivate management to focus on certain accounting ratios – earnings per share and gearing. As is shown in the literature, the temptation to influence certain accounting ratios is greatest when firms are close to breaching critical debt covenants, or management remuneration is linked to accounting data. It is noteworthy that creative accounting seems to have been a much lower public concern in the rest of Europe than in Britain. This is because of the fewer number of listed companies on the continent, and the tax-oriented focus of accounting (as opposed to a performance measurement one). With the rise in competition and the internationalization
of business coupled with a greater emphasis on accounting information, it is possible that creative accounting will become an important issue in the rest of Europe in the future. To the extent that accounting information continues to be an important measure of performance and accountability, and management command greater power than other stakeholders, it is unlikely that creative accounting will disappear.

This study focused on the accounting treatment of premium put convertibles, an instrument used by firms to practise creative accounting. Considering that the TFV principle is central to British accounting, it is surprising that a technical committee of the ICAEW, charged with providing guidance on a controversial accounting issue, was unable to make a firm commitment to accounting principles at the first opportunity when TR677 was issued, and instead left room for variable interpretation. This ambiguity was exploited, and few firms initially complied with its requirements, although later developments were to prove that the appropriate accounting policy was amortization of supplemental interest from the outset, irrespective of share price performance. It seems that the TFV principle, rather than preventing creative accounting, is much more tolerant and does not give enough strong backing to accounting standards.

Although constraints such as critical reporting by analysts and the media, coupled with firm stances by auditors, do exist, they were seen to be of varying effectiveness during the study period. There was some evidence of analyst and auditor bias and lack of independence, due to the existence of conflicts of interest. This provides companies with a time lag before there is adverse comment (if at all), and the weakness in the enforcement of standards and technical releases allows companies to avoid immediate repercussions. There are also varying degrees of creativity and the likelihood of adverse publicity and sanctions is unpredictable. Burton practised creativity to a high degree through premium put convertibles and off-balance sheet finance, and weak underlying performance in the business forced the opportunism to surface. Although Tesco pursued similar policies to Burton, it did not experience significant repercussions (such as a management reshuffle), because the underlying performance was healthy. The share price performance appeared to impact the degree of press monitoring of accounting practices. Tesco share prices performed much better than Burton prices during the same period, and Tesco attracted much less criticism from the press.

What the cases also show is that to focus purely on contracting influences in order to explain accounting choices is insufficient. Management have to balance motivating factors with the constraints on creative accounting, and in some cases, for example for companies highly concerned about their reputation (such as Tesco), adverse media comment can have an overriding influence. Corporate Governance factors such as the existence of independent audit committees and the diffusion of power through the separation of the
roles of Chairman and Chief Executive may also have an important restraining influence.  

Better quality and independent analyst research also play a potentially crucial role in restraining creative accounting. Standard setters and auditors usually examine accounting choices on a piecemeal basis whereas it is the analysts who examine the whole portfolio of accounting choices. When regulating financial reporting, the alternatives available are not simply state regulation versus free market. There are several intermediate alternatives, one of which could be to have state regulation and steer market forces in specific arenas. The evidence in the study suggests that there was inadequate investment in quality analyst research, and this is crucial if there is some reliance on market forces to regulate accounting practices. One approach is for the regulators to actively influence a private market for quality analyst research as suggested by Shah (1994). The credit rating industry is an example of a successful market-based approach to monitoring financial performance and default risk. This experience can be extended to equity analysis. This will avoid the problem of lags in response by regulators, and encourage the use of markets as a means of regulating accounting.

From an efficient markets perspective, the above examination of how financial information is analysed and disseminated in the markets suggests that there are significant costs of information analysis and interpretation, and the analysis process requires a certain amount of skill, which may not easily be available in the marketplace. For example, Smith (1992) was a bestseller because there was a dearth of good quality analyst research in the market place at the time, and in Smith’s book companies were named and the analysis had some depth rather than superficiality. It seems certain that in the 1980s’ UK environment, this skill was in short supply. In addition, when markets and share prices are bullish, the need and emphasis on good quality research may not be as strong, but when markets turn bearish, focus turns towards quality investment analysis and research. Critical reporting in the financial press appears to have a powerful influence on the share prices, although it is not necessarily done in a consistent manner and seems more haphazard. As we move towards an increasing information revolution, with a larger quantity and range of information provided through modern technology, there may not be a shortage of information. However, the skills needed to identify and segregate important information from trivia, and use this for investment decision making, will continue to remain important.

It is curious that in a context such as the UK, where there is a strong development of the stock exchange and of related services, creative accounting practices can still go undetected by the actors who are in charge of being the ‘watchdog’ of company behaviour (acting on behalf of investors). Therefore, even if these practices are likely to affect financial reporting in many countries, they have a special connotation in the UK because of the investor-oriented environment. The true and fair view formula, which has
been inserted in the Fourth EC Directive at the request of the British, does not seem to be able to cope successfully with the prevention of these creative practices and leaves room for opportunism, even in the country where it was first developed. Paradoxically, it was the UK who ‘sponsored and pushed’ the true and fair view legislation to the rest of Europe.

Although the present study is restricted to one country, there is potential for conducting similar studies in other countries, and also for comparative studies of accounting policy choice. Such studies would reveal the extent to which influences on creative accounting practices are similar or different between different countries. There may be differences in the range of factors which influence accounting choice and the mix of influences. Comparative studies, if carefully conducted, can teach us a lot about how different institutional settings influence accounting practices. The qualitative approach suggested here is particularly suited to address such questions more directly, and enhance our theoretical knowledge.

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NOTES

1 Interview with author, October 1994.
2 Source: Figures extracted from the annual reports.
3 These were disclosed in notes on directors’ remuneration in the annual reports, although no specific details of the scheme were given. For example, the Burton 1988 Annual Report stated in note 22: ‘The scheme is based on increases in fully taxed earnings per share, and a proportion of the benefit each year is set aside in an index-linked Deferred Compensation Scheme which vests after 4 years (or earlier if earnings per share double) contingent upon the continued service with the Group of the relevant Executive Directors’. Between 1987 and 1990, aggregate directors’ performance-related incentive payments were £7.2m for Burton and £4.3m for Tesco (Source: Annual Reports).
4 Borrowings have been defined in this study as (Creditors > 1 yr + Provision for liabilities and charges + Minority Interest)/Shareholders Funds are defined as (Capital + Reserves). Gearing ratio after Off-Balance Sheet Finance (OBSF) is (above numerator + OBSF liabilities)/Shareholders Funds.
The Group Chief Accountant of United Biscuits also confirmed in an interview that debt covenants were not restrictive as it was ‘able to negotiate slack covenants owing to its credit rating’ (personal interview, March 1995).

Personal interview, November 1991.

Twice voted the best analyst in his industry sector by an independent survey of analysts.

For example, Thorn’s policy of making a transfer against reserves was completely different from the rest. Its positive share price performance would suggest no need for accrual, but accrual was made. For those companies with a declining share price (Asda, Next), the timing of the change in accounting policy was different.

There was no separation of the roles of Chairman and Chief Executive in Burton, Tesco, Next and Attwoods, at the time when these instruments were issued and the creative accounting practised.

REFERENCES


