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Impact of Misstatement in Financial Statements on Investment Decision Making

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Abstract- Financial statements are prepared with the view that they will be a representation of transactions entered into by a firm in a financial year. These financial statements are examined by public accountants to certify that they show a true and fair; but it has been observed that despite this measure, there exist some misstatements, fraudulently or otherwise in the statements. These misstatements occur in areas where the accountant is at freedom to use his opinion where alternatives existed. This is the concern of this research paper titled 'Impacts of misstatements in financial statements on investment decision making. It is a descriptive study that is designed to examine misstatements in financial statements and how they are able to distort results of calculated ratios and their interpretations that most investment decisions are based upon. Three types of financial statements were considered and they are balance sheet, profit and loss account and cash flow, where most ratios are derived. Interviews and opinions of experts who have had practical experiences in industry as accountants and auditors guided the authors in their study. The study found out that there are several areas of a firm's financial statements that are misstated, such as impairment of assets, inventories, receivables, accrued expenses, etc. Solvency is affected, liquidity is affected efficiency in assets utilization is affected, and also, profitability is affected. This is the reason investors should be aware that misstatements impacts on ratios negatively, therefore should be more diligent in ratios analysis and interpretations. Auditors are not likely to uncover all the misstatements, hence investors may resort to other sources of information about a firm's performance to complement ratio analysis.

Index Terms- Fraudulent misstatements, investment decision, financial statement frauds, impairment of assets, subjective opinion

I. Introduction

Financial statements are prepared by the accountant in an organisation to depict its financial results, financial position, and cash flows. The laws of most nations placed the responsibility of preparing financial statements in the domain of companies' directors, and this is further delegated to the accountant. This culminates to preparation of some important reports as balance sheet, income statement, cash flow statement, and statement of retained earnings.

II. Types of Financial Statements

There are different types of financial statements; statement of financial position (balance sheet), income statement (profit and loss account), cash flow statement, and statement of retained earnings. And these report or statements serve different purposes. **Balance sheet.** The balance sheet reveals the financial position or health of an organisation through a display of its assets and liabilities. The items here include share capital, reserves and surplus, long term borrowings, and current liabilities (liabilities); fixed assets, long term investments, current asset (assets).**Income statement.**The profit and loss account shows the operating results of the organization. Here is displayed the revenue, purchases, inventories, operating expenses, profits (losses) etc. **Cash flow statement.**The statement provides a summary of an organisation's operating investment, and financing cash flows and reconciles them with its cash and marketable securities during the period. It gives an insight of sources of cash received and cash paid in a given period. **Statement of retained earnings.**It reconciles the net income earned during the year, and any cash dividend paid, with the change in retained earnings between the start and end of that year.

Investors, creditors, and other users of the financial statements have so much confidence in the contents of these statements, especially, when they are examined by auditors. But this confidence seems to be eroded by the nefarious activities of management to, in most cases, intentionally misrepresents the fact. This has led to varying degrees of frauds and misstatements in the financial statements.

The depth of this problem can be evaluated by the fact that on daily basis, there are reports of one kind of fraud or the other in financial statements of different companies globally. This has led to the collapse of manymultinational companies (MNCs), e.g., Enron, and the failure of corporate governance is at the heart of this misfortune.

The purpose of this paper is to spotlight common critical areas that misstatements occur in financial statements. It will also try in a modest way to advance reasons for such misstatements, whether they are deliberate or otherwise. And it shall consider the extent to which investors rely on the contents of financial statements for their investment decisions.

The most important functions of accounting entail that the accounting numbers should have the following qualities:
Understandability, Relevance (materiality,& timeliness), Reliability, Completeness, and, Comparability.

This agrees with the provisions of the framework of the International Accountants Standards Boards (IASB: 2001).

Withthis achieved, it can fulfil the expectations of the different users, including investors. The standard practice all over the world is that practising accountants are appointed to examine the financial statements and attest whether they are true and fair in their report. This brings to mind the question of accuracy in the accounts, this to a large extent, is a matter of degree and interpretation. This means that 100% accuracy cannot be guaranteed. The auditors do what is statutorily possible to ensure accuracy, they can only achieve accuracy to the extent of their expert opinion. There is the view that accounting numbers are reliable because they are confirmed to be so by experts who take due care in the exercise of examination of the records. And to do otherwise means we are left to take our destiny in our own hands. The auditors observe due care because of the provision of prosecution in case of established negligence on their part. The financial statements need to be provided on timely basis for them to be useful.

III. REVIEW OF LITERATURE

We shall, under this section consider some past studies in relation to the topic. This will help in having better understanding on issue already in the public domain as revealed by these authors. The responsibility of preparing the financial statements is on the Board, whose duty it is to ensure that contents of the statements are reliable, true and fair. The International Federation of Accountants (IFAC:2002) also emphasizes this position.

Preparation of financial statements are done in India and other countries according to Generally Accepted Accounting Principles (GAAPs). The principles have the function of directing and guiding preparers of financial statements of how various items should be treated in the books so that the items will convey same meanings and understanding to different users who are financially literate.

Common misstatements in financial statements

The Association of Certified Fraud Examiners (ACFE) has made far reaching findings and report on financial misstatements and are disturbed because of the magnitude of the crime. The study of ACFE in 2012 reveals that those with higher level of authoritytend to cause larger losses by fraudulent financial statements (ACFE Report 2012).

The Indian Accounting Standards (Ind AS) framework, paragraph 1.12 states that the objective of financial statements is to provide information about the financial position, performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. And the International Accounting Standards 1:13 also reiterates that financial statements 'shall present fairly the financial position, financial performance, and cash flow of an entity.

Rees (1995) opines that managers, in a bid to make their accounts look attractive, by judicious choice of accounting policies and applying bias where estimations are allowed.

Rees(1995) also makes analysis of Smithand Hannah(1991) where the latter made a classification of common misstatements found in financial statements of entities into 11 groups:

1. Excessive provisions. Goodwill is overstated and not expensed, thereby increasing profits.
2. Extraordinary items. Significant reorganization/rationalization costs shoed as extraordinary items.
3. Off balance sheet finance. Loans not shown on balance sheet.
4. Capitalised costs. Inappropriate capitalisation to reduce costs.
5. Non-trading profits. Such profits as normal earnings figure.
6. Brand accounting. Brands showed as intangible assets.
7. Depreciation ratio change. Reduction in depreciatio9n policy to show growth.
8. Pension and holidays. Reduction in pension fund contribution shows larger pre-tax profits.
9. Earn-out commitments. Profit sharing scheme to personnel.
10. Foreign exchange mismatch. Mismatch between debts and deposits.
11. Low tax charge. If low tax charge appears, profit manipulation probable.

This study is actually very old that we may rightly say it is outdated, but the underlying findings appear to be as relevant today as they were when it was first carried out.

Horwitz, Kolodny(1981) wrote on 'research and Development (financial statement capitalization)' tested hypothesis of No decline on expenses. This hypothesis was rejected because there was a reduction in expenses as a result of capitalising R/D expenses which increased reported profits. This view is envisaged in IAS 38 in respect to intangible assets. This expensing of R/D is also discussed in Lev, Sarath, Sougiannis(2005), where question are asked about when principle of conservatism is followed or mere aggressiveness, since no procedure can be constantly and justifiably conservative or aggressive. Bias about R/D made PWC to issue industry alert to Pharmaceutical and Life Sciences Industry because of the complexity of funding and reporting R/D expenditures. On this note, Chhatwal(2014) studies the relationship between R/D and Sales and found out that R/D affects sales because of the uncertainty of how it will be treated in the books.

In the work of Gupta and Gill (2012), 'Prevention and detection of financial statement fraud-An implementation of data mining framework' a more scientific and computer based way to prevent and detect financial misstatements in the financial statements. They identified and collected 62 featuresfrom financial statements of 114 organizations; and found 35 informative variables by using one way ANOVA to identify ways to detect and prevent financial statements fraud.

Riedl. Srinivasa (2010) investigates the presentation of special items in the financial statements if they reflect economic performance or opportunism. Some of these special items are presented as separate lines in the income statement while others are merely shown as footnotes.

Feroz et al (1992) did analysis of accounting misstatement according to (SEC) investigation and concludes that in most cases, trade receivables were major source of misstatements, followed by inventories, investments, and long-term assets.

Causes and reasons for misstatement of frauds in the financial statements

Frauds and misstatements in financial statements has led to collapse of many organizations, especially large corporations. This has made researchers to doubt the accounting numbers to certify the information needs of users. Even when these statements are examined by the auditor, who is generally believed to ensure accuracy, reliability, and conformity to Generally Accepted Accounting Principles (GAAPs).

There are a number of studies on causes and detection of frauds in financial statements,Gupta and Gill(2012), where data mining methods are used to detect and proffer solutions to financial statements frauds. Frauds in this regards has been severally defined. It is said to be coercion of people such that they will act against their own best interest. Fraud is an intentional act meant to induce another person to part with something of value, or to surrender a legal right. The Association of Certified Fraud Examiners (ACFE) defines financial statements fraud as 'The intentional, deliberate, misstatement, or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgement or decision.' And to make the situation worse, this financial statements frauds are committed by top level management, those having the responsibilities to prepare a fraud free statements.

According to Rezaee(2005), financial statements frauds involve the following:

1. Falsification, alteration, or manipulation of material financial records, supporting documents, or business transaction
2. Material intentional misstatements, omissions or misrepresentation of events, transactions, accounts, or other significant information from which financial statements are prepared
3. Deliberate misapplication, intentional misinterpretation, and wrongful execution of accounting standards, principles, policies, and methods used to measure, recognize, and report economic events and business transactions
4. Intentional omissions and disclosures or presentation of inadequate disclosures regarding accounting standards, principles, practices, and related financial information
5. The use of aggressive accounting techniques through illegitimate earnings management
6. Manipulation of accounting practices under the existing rules-based accounting standards which have become too detailed and too easy to circumvent and contain loopholes that allow companies to hide the economic substance of their performance.

Causes of financial statements frauds

The existence of corporate governance may not completely eliminate financial statements frauds because of other factors. In the opinion of Rezaee (2005), financial statements frauds has cost market participants, including, investors, and more than 500billion dollars during the past several years. The paper shows that 'cooking the books'constitutes financial statements frauds which is a crime. He concludes that due to the complexity of the crime, detection and prevention should be intensified.

Cressey (1986) classifies causes of financial statement as; opportunity, attitude or rationalization, and motive or pressure.

Opportunity is a situation that presents itself such that management has the chance to perform material misstatement in the financial statements; such as weak or lack of internal control, absence of proper audit committee, etc.

Rationalization being the ability to act in self-perceived moral or ethical values that should be accepted by others as most appropriate thing to do at the circumstances. Management may claim doing for the interest of shareholders.

Motive could be under pressure to commit financial statements fraud, this may be as a result of poor cash position, to please customers.

Methods used in presenting fraudulent financial statements

I. Overstatement of revenue by inflating sales
II. Understatement of expenses. This may be by capitalizing expenses
III. Overstatement of assets, by not booking down accounts receivables
IV. Understatement of liabilities
V. Improper use of reserves
VI. Mischaracterization as one-time expense
VII. Misapplication of accounting rules
VIII. misrepresentation

Do investors consider the possibility of financial statements fraud in an audit?

Publicly quoted corporations are required by law of different countries and international laws that the corporations are required to appoint auditor(s), to examine the accounts of the company and report whether the accounts show a true and fair view. The International Accounting Standards Board(IASB), Indian Accounting Standards (IndiAS), etc., reveal the same intent and purpose. The auditors exercise due care and plan their audit such that negligence is exhibited in course of their duty. Does this duty of care and diligence stop investors from considering the accounts numbers carefully, before making investment decisions?

The way investors perceive published accounts is shown by interests researchers have demonstrated to the study of value-relevance of financial statements. Francis and Schipper (1999), are concerned about the relevance of the accounting numbers and wrote on 'Have financial statements lost their relevance? Piotroski (2000), in his popular article 'Value investing' also discussed this same issue; Hung (2001); Chen, Chen and Su (2001) etc., were interested on the value-relevance of financial statements. This is the reason it is believed among financial experts that proper handling of the accounting numbers enhances financial decision-making process (Zager and Zager: 2006), ibicioglo, Kocabiyik, and Dalger: 2010.

Analysis of financial statements

There are varied users of the financial statements; and their areas of concentration will differ depending on what they set their minds to achieve. These users include investors, creditors, management, researchers, Tax Authorities, the general public, etc. They would generally do financial statements analysis, which involves ratio analysis. Ratios are calculated and analysed based on the accounting figures in the financial statements; and as examined by public (practising) accountant. The ratios are grouped into four main segments:

Leverage or Solvency Ratios.
Debt to Assets = Total Debts/Total Assets
Debt to Equity = Total Debts/Total Equity

Activity or Efficiency Ratios. Analyses efficiency in the use of firm's assets.
Inventory Turnover Ratio = Cost of Goods Sold/Average Inventory
Receivables Turnover = Sales/Average Trade Receivables
Payables Turnover =Purchases/Average Trade Payables
Working Capital Turnover = Sales/Average Working Capital
Fixed Asset Turnover = Sales/Average Fixed Assets
Total Assets Turnover = Sales/Average Total Assets

Liquidity Ratios. Analyse ability to meet current obligations when due.
Current Ratio = Current Assets/Current Liabilities
Quick Ratio = Current Assets – Inventory/Current Liabilities
Cash Ratio = Current Assets- Inventory-Accounts Receivables/current Liabilities

Profitability Ratios.
Gross ProfitMargin = Gross Profit/Sales
Profit (Net) Margin = Net Income/Sales
Return on Assets = EBIT/Average Total Assets

Return on Equity = Pre-Tax Income/Average Equity

Other Valuation Ratios.
Earnings per Share (EPS)

IV. METHODOLOGY

This study is completely a descriptive one, as the authors are trying to x-ray fraudulent misstatement in the financial statements and ways to detect and prevent them.

Discussion

Financial statements users, especially investors and creditors, place much confidence on the reliability and correctness of the accounting numbers, to guide them in making investment and lending decisions. This is on the premise that the statements have been examined by certified public accountants; and this may be misleading as misstatements still find comfort zone in the financial statements.Fraudulent financial reporting is almost seen as part of reporting,especially the management fraud. Even the highly rated audit firms fall short of identifying all error and frauds in the books they audit. However, their diligence and compliance to generally accepted auditing standards reduces such misstatements. What should be done by users?

Leverage ratios- a careful analysis of leverage ratios will ultimately reveal a potential risk of insolvency of the firm. This category of ratio shows the level a firm has utilized outsiders' fund to finance the capital or finance assets. A high leverage ratio, shows that more debt financing is adopted by the firm than owners' fund. The danger here is that obligation to the providers of outsiders fund must be met, otherwise, it may lead to loss of credibility, and sometimes litigation. However, if the firm is an industry that requires heavy investment in equipment and research and development (R/D), then check the cash flow whether it is robust and consistent, so to be able to sort out these obligations of the outsiders. Moreover, industries that require regular upgrade of facilities need heavy investment in equipment and this cannot all be borne by owners, hence the necessity of debt financing in such industries. Such huge investment will spur up production, leading to more sales of modern products, and more income. To ascertain the impact of debt on profitability, interest coverage ratio is computed, which will show the extent to which earnings may fall without causing serious concern and embarrassment to the firm in terms of paying fixed interest charges. A high ratio indicates an excessive use of debt, therefore, a low ratio is desirable. And bearing in the nature of the industry. Management could misstate the financial statement by means of manipulating depreciation. Inventory, and other related items could influence earnings before interest and taxes.

Liquidity ratios-provide a quick test of the ability of a firm to settle its short term debts without undue stress. Items of inventory and receivables could be manipulated to appear as though the current assets are far ahead of current liabilities, portraying a sound liquidity position. A firm with low level of liquidity that is not supported with a robust cash flow is likely to have the threat of reneging on debt obligation or asking for understanding from its creditors, by renegotiating the payment schedule. A general low liquidity typified by low current ratio and low quick ratio is a danger signal of bankruptcy that should be avoided.

Activity ratios- is about the velocity at which inventory is sold and replenished and efficient utilization of assets and other resources to operate with minimum loss and high profitability. Misstatements that affect profitability are at the heart of every intent to present the financial statement better than what they are actually are. A comparison of the activity ratios over time will direct our minds to the level of efficiency. Wide gaps in-between years should be studied carefully to ensure that all is well. When there is continuous production activities, it will give rise to increase in sales and by extension revenue.an increase in revenue increases profit which is good for the business.

Profitability ratios—guides to determine whether the firm is doing well or not, and if the stockholders are benefitting from the profits generated by the firm by way of dividends payment. A firm seeking for credit could present an otherwise impressive statement to pave way for their loan request, or give impression of regular payment of dividends to convince investors to plunge into the murky water typified by ugly state of affairs in the company. High profitability ratios is an indication of good omen for the firm and the shareholders.

Specifically, areas where misstatement often occur are the following:

Impairment of Assets. IAS-36 as amended intends to ensure that assets are recorded in the books at values more than their recoverable values when sold or transferred. An impaired asset is a company's asset that has a market value less than the amount stated in the books. The assets that affected are those that involve judgement to be exercised by preparers of the financial statements. They include: Goodwill, accounts receivables, and long-assets, because their carrying value has a longer period of time for impairment. Goodwill involves estimation of future cash flows that are generated from fixed assets or goodwill; and are done subjectively, not necessarily based on definite calculation or scientific reasoning. This is more obvious when determination of fair value is to be made. This is why it is prone to misstatement in the financial statements.

Another important asset that is affected in this issue of impairment is Work-in-progress. Timing of recognition of cost is a major problem in the construction industry, and it is often subject to fraud of misstatement in the financial statements. Some contracts take a very long time to completion, thereby involving high degree of estimation in completion rates at different stages of completion.

Inventory is among the assets subjected to different opinions on its valuation, there may be inadequate provisions for damages, obsolete inventory becoming obvious because of slow-moving stock. These may be misstated because the accountant applies opinion which is subjective. Inventory affects current ratio in determination of a firm's liquidity and other ratios.

Receivables are easily misstated by making inadequate provisions for bad and doubtfuldebts. Some of these debts are left to be outstanding for too long that should be fully recoverable. This could be done to show better liquidity status of a firm. Here, the liquidity ratios are affected such that they may portray positive and comfortable liquidity position.

Sometimes, liabilities could be subject of misstatement in the financial statements. The item mostly misstated relates to accrued expenses as it concerns litigation, environmental issues, etc. When accrued expenses are not properly recognized at the end of a financial year, financial position will be affected. Profitability ratios will be affected, analysis and interpretation of vital indicators of the company might be misleading.

V. Findings

This is a descriptive study that investigates the possibility of misstatements in financial statements and their impact on investment decisions. Result of the study reveals the followings:
There are certain areas of the financial statements that are usually misstated, some being more obvious than others;

The areas misstated are those areas where their treatment in the accounts are subjective, leaving the accountant to decide which option to adopt at a particular circumstance.

Preparers of financial statements will intentionally select an option that misstates the statements fraudulently with the leverage available to them to choose the method to use.

Investors rely on the auditor and thinks that financial statements could be relied upon for investment decision, having been examined by the auditor.

Assets are misstated than liabilities, but they both have negative impacts on investment decisions.

Most devastating misstatements are top management driven, and they are huge task to curtail since management is usually determined to defend its decision and actions.

VI. Suggestions

Users of financial statements, especially investors should be aware that the statements could be fraudulently misstated, to mislead users, hence, should look more carefully on the areas that prone to misstatements.

Auditors do not guarantee absolute accuracy and correctness of the accounts, but after careful planning execution of an audit express opinion on its truthfulness and fairness.

More studies should be done on how to reduce areas of misstatements in the financial statements.

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