Indicators of Misreporting: A Review

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Abstract-Financial scams are not far from the headlines, despite the efforts of regulators, auditors to combat fraud; the number of companies indulging in manipulation has been increasing. Global fraud 2015 reports that the number of companies suffering a financial loss has increased from 64% in the year 2014-15 to 69% in the year 2015-2016. The corporates have been deceiving their stakeholders and making huge money by manipulating the financial statements. Although these increasing scams have made the auditors to make a strict scrutiny of financial reports, it is better for the public to be self-aware of the indicators of fraud and misreporting before associating with the company. This paper of fraud and misreporting attempts to provide a holistic view of indicators of misreporting. Studies on misreporting and fraud have shown accounting indicators and corporate governance indicators whereas this paper extends the study to the extent of laying out few of the common characteristics of companies that have manipulated or accused of manipulation. This paper also brings out the thin line that distinguishes Earnings Management and manipulation, hence it warns the investors and the general public about the malpractices followed by the companies and helps them to take a wise decision before associating with the company

Keywords: Accounting, Earnings Management, Corporate Governance, misreporting

1. Introduction

The scandals of big companies like Enron, WorldCom, Tyco, Satyam have obligated the need to be more cautious before establishing any relation with the companies. Be it a bank lending money, an investor investing his savings, or an underwriter giving surety to purchase the shares, everyone must ensure there is nomisreporting in the financial statements by assessing the overall activities of the company. This study aims to help the general public to be cautious about the misreporting activities by showing the various indicators of misreporting. There are studies showing accounting manipulations and corporate governance indicators, but this paper extends the study by showing the probability of misreporting through earnings management, distinguishing Earnings Management from manipulation. Further, this study also brings out few of the characteristics of a company through which it's reliability could be determined. Earlier studies show that the common accounting manipulations are Inventory (Spathis,2002; Dalniala et al., 2014;Rosner, 2003;Bai, 2008), Debt level (Yucel, Elif, 201;Dalniala et al., 2014; Spathis, 2002). Few indicators as Liquidity (Spathis,2002;Dalniala et al., 2014), Cash flow (Rosner, 2003; Yucel, Elif, 2013;Magrath et al., 2002) receivables (Bossard, 2004;Bai, 2008;Magrath et al., 2002;Dechow, 2011) have been proved effective measures to detect manipulation. Accruals is one of the tools that is often used for misreporting. However, it does not mean that all the companies following accrual based accounting tend to misreport the financial statements. The presence of larger accruals is a red flag. Brazel et al. (2009) pointed out that accruals can be measured as the difference between the actual earnings and cash flow. Users of financial information must be cautious about increasing difference between actual earnings and cash flow. Two measures through which accrual quality can be analyzedare change in receivables and inventory, these accounts are directly linked to revenue recognition and cost of goods sold, both of which impact gross profit (Dechow et al. 2011). Agnes et al. (2010); Huang et al. (2014) and Bhagat and Black (2000 and 2002) highlight the important indicators of corporate governance viz. CEO duality, board size, independent directors, stock-based execu-

tive compensation, presence of domestic and institutional investors. While some studies show a positive relationship between occurrences of fraud and earnings management (Yen, 2013; Huang et al. 2014), other studies do not consider earnings management as fraud (Goel, 2012; Stlowy and Breton, 2004; Sun and Rath, (2008). This paper brings forward both the points of view.

2. Accounting indicators of misreporting

Rosner (2003); Brazel et al. (2009); Callen(2008) and Wuerges (2014) discuss the accounting indicators of misreporting. The information pertaining to the indicators can be obtained from the 10 K, 10-Q,8K of the SEC filings. Companies often desire to show good earnings in order to increase the share price of the company. In lieu of showing good earnings, they tend to misreport in the financial statements.

2.1 Manipulation through Accrual based accounting

Accrual based accounting requires the companies to record the revenue earned irrespective of whether cash is received or not received; similarly, it allows the company to record unpaid expenses. Companies that follow accrual based accounting have often subjected to manipulation (Brazel et al. 2009), however it does not necessarily mean that all companies following accrual based accounting tend to manipulate. To determine the presence of manipulation one must check the extent of accruals. Brazel et al. (2009) also point that the level of total accruals can be determined by the difference between earnings and cash flow from operations. Hogan et al. (2008) find that, unusual accruals are the main reason for manipulation. The companies use accrual based accounting to overstate the revenue by recording income that has not been received yet, to show high earnings for that particular period.Thus it becomes necessary to compare the operating cash flow with the income earned.

2.2 Low Cash flows compared to revenue

Comparisons of cash flow with earnings can reveal manipulations. Rosner (2003) shows that a larger difference between the cash flow and earnings is a sign of manipulation. Larger difference can indicate that the company has inflated the revenue by recording sales in inappropriate period (Magrath et al., 2002; Lasko et al. (2011). Callen et al. (2008) find that companies that tend to manipulate have a negative cash flow during the period prior to manipulation, which means that the company is trying to conceal continuous losses.

2.3. Low Liquidity

The composition of current assets or the liquidity position of the company can indicate the chance of manipulation. Wuerges et al. (2014) find that companies with higher change in current assets than change in total assets are less likely to be involved in manipulation. Users of annual report must be cautious about the companies which have low liquidity over a certain number of periods. Schilit et al. (1993) prove that companies with low liquidity often tend to manipulate.

2.4. High Receivables

Among current assets, it is identified that inventory and receivables are the easy target and often subjected to manipulation (Bai, 2008; Beasley et al., 1999; Asare and Davidson, 1995). Bai (2008) suggests that, in order to identify manipulation through receivables one must look at the receivables as a percentage of revenue. Vladu et al. (2016) propose that there is a high probability of manipulation when there is an unusual increase in receivables. More receivables than revenue could mean, the company is recording fictitious sales or the customers are facing financial distress to pay to the company. This is evident in the case of Lucent crash, where the company inflated its receivables by 49% but the revenues increased only by 20%. As the receivables rise, there will be some portion of it that cannot be collected, for which a company must make reserves, but in the case of Lucent the reserves decreased for uncollectible accounts whereas the Receivables kept increasing. Thus here is the red flag that can be waived if the reserves for uncollectible accounts does not match with the Receivables (Magrath and Weld, 2002).

2.5. Large inventory

Slow moving inventory or high inventory is not a good sign for a company. Dalniala et al. (2014) investigate the significant differences in means of the financial ratios and find that the mean ratio of inventory to total assets showed a difference for fraudulent and non-fraudulent firms. Results of Dalniala et al. (2014) and Spathis. (2002) show that the fraudulent firms have high inventory over sales while, Wuerges et al. (2014) suggest that high inventory could also mean that the company is inefficient in generating sales. Hence it is desirable for investors to check the inventory to total sales ratio.

2.6. High debt level

Any stakeholder planning to establish relationship with a company that has high debt level must be cautious because high debt level is associated with high risk. High interest expense results in volatile earnings. Schilit et al. (1993) advocate that companies with high debt level often tend to manipulate. Results of Vladu et al. (2016) show there is an increase in the probability of fraud in the firms with the high leverage. The financial ratios that can be helpful in detecting high levered firms are, Total debt to Total equity and this has been proved as an effective indicator to distinguish fraudulent and non-fraudulent firms (Dalniala et al. 2014). Leverage ratio that is provided in the study of Wuerges et al. (2014) is Total Liabilities by Total Assets.

2.7. Decreasing profitability

Continuous decrease in profitability in a company for a certain number of periods, is obviously not good sign to establish any relationship with that organization. However, to bring to the attention of the users, the study of Wuerges et al. (2014), Jensen and Marshall (2007) and Gaganis (2009) said that ROA is negatively related to the probability of manipulation. The rationale behind this is, decreasing profitability will induce more pressure on the corporates to show a better picture to the stockholders thus they tend to overestimate the profits.

3. A thin line that separates Earnings management from Misreporting

Schipper (1989) Healey and Wahlen (1999) define earnings management as “practice of using tricks in order to misrepresent or reduce the transparency of the financial reports”. Yen and Shih-Chung (2013) investigated accused Chinese companies and found a positive relationship existing between occurrences of fraudulentfinancial statement and Earnings Management. Huang et al. (2014) tested the suspected Taiwanese firms, where it was revealed that Earnings Management has a positive relation with the Illegal insider training but Goel (2012) says earnings management is not a manipulation and often financial analysts, investors, auditors fail to distinguish the very thin line of difference existing between financial statement manipulation and Earnings management. He also added that earnings management is not same as manipulation but it is the result of aggressive application of accounting principles and interpretations subsequent to which results in misreporting. The definitions of Earnings Management from the academic point of view aligns with that of the definition of Generally Accepted Accounting Principles (GAAP) for management discretion as classified by Sun and Rath (2008), whereas SEC classifies earnings management as outright fraudulent accounting activity. Stlowy and Breton (2004) provides the framework which determines that any activities relating to Earnings Management that is within the preview of law is not considered as accounting manipulation, while the accounting that does not fall within the law is undeniably a manipulation, further they distinguishes the two terms by defining Earnings Management as "the use of management's discretion to make accounting choices or to design transactions so as to affect the possibilities of wealth transfer between the company and society (political costs), funds providers (cost of capital) or managers (compensation plans). In the first two cases, the firm benefits from the wealth transfer. In the third, managers are acting against the firm”. In spite of having common features both are directed to deceive and is aimed for a private gain, if the accounting is within the compliance of GAAP, it cannot be regarded as manipulation but however as per the authors view, investors must be careful about the accounting practices followed.

4. Corporate governance indicators of misreporting

Using solely accounting indicators may not give the right method for detecting manipulation; this paper sheds lights on few of the corporate governance factors which can help in distinguishing a reliable and unreliable company

4.1. CEO Duality

Agnes et al. (2010) hold that a company with the same person as a CEO and chair have ahigh probability to manipulate the accounts through transfer pricing because the board will have less power compared to the joint CEO and Chair to restrain any manipulations. Baliga et al. (1996) reported that Duality affects the firm performance as well. GM had a dip in market capitalization and shareholder's equity to $6.2 billion from $36 billion, IBM lost its market value from $106 billion in 1987 to $27 billion in January of 1993but the results ofHuang et al. (2014) proved with the suspected Taiwanese firms that there was lower probability of illegal insider trading in companies that had CEO duality and domestic investors.

4.2. Stock-based executive compensation

Bergstresser and Philippon (2002) study shows that there is a high probability of manipulation where managers hold large stock option portfolio. Summers and Sweeny (1998) found that in the presence of any manipulation, the management indulges in selling activity to inflate the stock prices. This can happen if there is large amount of stock-based compensation. Johnson, et al. (2003) investigates the companies accused of fraud and the companies not accused of fraud; they have concluded that there are higher financial incentives to inflate the stock prices in the firm accused of fraud than the firms not accused of fraud. Cheng and Warfield (2002) showed in their study that there is a positive relation between the increase in stock-based compensation and the increase in abnormal accruals, further it was also found that stock-based compensation can reduce the earnings.

4.3. Presence of Domestic and institutional investors

According to Young et al., (2008) the foreign investors have a better monitoring ability and it can improve the transparency in dealings, this factor makes a company more reliable. The presence of institutional investors can improve the firm value and reduce the insider trading. D'Souza et al. (2005) hold an opinion that a firm with foreign investors can have a better controlling and monitoring and avoid internal conflicts between the local investors. Authors found there is a positive relation between presence of foreign investors and firm performance (Taylor, 1990; Oxelheim and Randoy, 2003; Kirkpatrick et al., 2006; Sulong and Nor, 2010; Ghazali, 2010 and Taufil et al., 2013). An investor whole decision can always check if the foreign investors have their share in the company, this can ensure them with a better reliability and increase their wealth as the stocks of such companies will more likely have a greater demand (Choi et al., 2012).

5. Other characteristics of a company that can indulge in manipulation

Few of the characteristics are listed and shown so as to create a general awareness among the public. Morsfield and Tan 2006; Hochberg 2012 holds an opinion that a company backed by Venture Capitalists (VC) are trustworthy because they found less abnormal accruals to be present in such companies. Wongsunwai (2013) found fewer chances of manipulations in an IPO company that are backed by high-quality VC's. Jennifer and Lorainne (2015) highlighted that companies accused of manipulation have higher volatility or Coefficient of variation in share price. Clive and Jeffrey (2010) emphasized that firms audited by Big Five (Arthur Andersen, Ernst & Young, Deloitte, KPMG, and PricewaterhouseCoopers) have a lower probability of indulging in manipulation than those companies that aren't audited by Big- Five. Sunita and Jagdish (2012) showed the textual indicators in the annual report by analyzing fraudulent and not- fraudulent companies, where six categories of linguistic indicators were found from the annual report, below mentioned are those indicators:

(a) Usage of complex sentential structures,

(b) Difficulty in reading and comprehension as measured by readability index,

(c) Use of positive tone
(d) Use of passive voice,
(e) Use of uncertainty markers
(f) Use of adverbs

Lorraine and Leonard (2002) warns about the earnings of the company constantly matching the analysts' expectations. Bales (2009) revealed the fact that manipulation is generally caused by the owner of the company and there are fewer chances of manipulations caused by the managers or non-managers. Simpson (2013) tested the relationship between investor's sentiment and earnings of the company, his results showed an increase in earnings when the investor's sentiment are high and lower earnings during the low investor's sentiment. Jiraporn (2007) examined the companies with Employee Stock Ownership Plans (ESOP); she concluded there is lower possibility of Earnings management in companies which offer ESOP's. The rationale behind this hypothesis is, the manger's interest is aligned with the shareholder's interest hence managers will not look forward to indulging in manipulation. The second reason he pointed out is, ESOP's make the employees of the firm loyal, due to which they look forward to a better company's growth rather than indulging in short terms window dressing. Dechow et al. (2011) found to have unusually high operating leases in the year of misstatement. Operating leases are used to show a low reported debt. Although it can be one of the 'legal' tools used for earnings and balance sheet management tools it is better the investors are aware of this fact. Manojj. M (2015) shows that there is productivity in terms of turnover in spun-off companies. The better productivity increases the stock price. Further in spin-off, good corporate governance protects the shareholder's value. Thus it is favourable for the investors to purchases stocks of spun-off.

6. **Conclusion and findings**

This study reviews various indicators of misreporting that can be identified from the financial statements and other reports. In this study, we have put forward various types of indicators of misreporting and provided a holistic view. We hereby conclude that following are the indicators that can be easily used as a means to detect manipulation.

6.1 Huge accruals

From our study, we have come to the conclusion that, larger accruals is either due to inflating revenue by recording sales in inappropriate period or recording fictitious sales. Thus, accruals can be measured by

Total accruals = Earnings – Cash flow

6.2 *High Receivables*

One of the ways through which companies can show huge accruals is by recording receivables. To know the extent of receivables recorded, one can take the ratio of *Receivables to Revenue*

6.3 Low Liquidity

If the liquidity ratio is way too low than the industry average then it is not advisable for making an investment in that company, this aspect is important especially to the debentures holders, organization lending money

6.4. Large inventory

From our studies, we conclude that it is not favorable to invest in a company that has alarge inventory. slow moving inventory could either mean the company is not generating enough of sales but however if the industry is growing and the company is spending enough on marketing, then the problem is not with sales.

6.5 High debt level

Highly levered companies tend to pay more interest which in turn decreases their profitability, from our study we conclude that it is unfavorable to invest in a company which shows the downward trend of profits. To determine this one can look into the trend of ROA, Net Profit Margin

6.6. Presence of institutional and foreign investors

It has been found that it is more reliable for an investor to invest in the company that has institutional and foreign investors because the company is obligated to have ahigh level of transparency with timely reporting.

6.7. Companies backed by Venture Capitalists

Companies backed by VC's were found to have less abnormal accruals, as they become

highly accountable for the every money that has been invested in the company.

6.8. Companies audited by Big Five

These companies are more reliable as they are subjected to strict scrutiny, the studies also showed less probability of manipulation in such companies

Although research indicates this as a reliable indicator of non- fraudulent company, the case of Enron has proved wrong.

7. Limitation

The study considers only those aspects that are found relevant from the literature and which can be easily detectable from the available secondary data. However, there can be further scope in tracing out few more characteristics and indicators of misreporting. The study does not look at the particular industry or country instead it aims to see the general overview of misreporting. Further research can be extended by studying misreporting with regard to the particular country or industry.

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