FINANCIAL STATEMENTS REPORTING AS A TOOL FOR MANIPULATING THE PERCEPTION OF ACCOUNTING INFORMATION

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Abstract: Financial statements must present the property, financial position, and performance of entities truly and honestly. Managers, however, may influence users' perception of information by altering the manner in which this information is presented in financial statements. The objective of this paper is to employ a slightly different approach based on the specific features of the parties involved in the information-exchange process, i.e. users (with their expectations and constraints) and managers (with their goals and motives) and review different methods and techniques applied by managers to manipulate users' perception of the information presented in financial statements.

Key words: financial statements; presentation; manipulation; qualitative characteristics.

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Introduction

The objective of financial statements is to provide information on entities' property, financial position, performance, and cash flows, so that users would be able to make their economic decisions based on objective and neutral information which is mainly presented numerically. Financial statements information also needs to possess the following qualitative characteristics: relevance, faithful representation, comparability, timeliness,

understandability. These characteristics are largely abstract and subjective and are therefore difficult to measure.

The underlying **thesis** of this paper is that information about transactions and events might be interpreted differently, depending on the manner in which it is presented, therefore managers often seek to create a certain perception in users by applying different approaches to the presentation of financial information. Users, in turn, perceive and interpret information differently according to their expectations and expertise in business and financial reporting. Hence, we may assume that the perception of any information might be influenced by two groups of factors. The first ones refer to those who prepare the information and their *motives*, while the second relate to those who perceive the information and their *expectations*.

The **aim** of this paper is to apply a slightly different approach which is based on the characteristics of both parties involved in the information exchange process (i.e. consumers with their expectations and constraints and managers with their goals and motives) and to highlight the major methods employed to manipulate the perception of information presented in financial statements.

To accomplish this, we have identified the following **tasks** of our research work:

1. Present the qualitative characteristics of information provided in financial statements;

2. Review the specific features of both parties involved in the information exchange process since they determine their attitude to the presentation and hence the perception of information provided in financial statements;

3. Identify the major methods and techniques employed to manipulate the perception of accounting information and thus bring them to the attention of accounting information users.

The **subject** of this research relates to the financial statements prepared by entities, while its **object** is the variety of approaches which managers employ in the presentation of information in order to manipulate users' perception.

The focus of attention here is on the way in which information will be subjectively perceived and interpreted rather than on its objective qualities. The mechanisms through which it is possible to affect the sums recognised in financial statements have been omitted from the scope of our research (whether or not they are in compliance with law – for example by choosing certain accounting policies; preparing transactions so that they will match a specific accounting treatment; or violating regulations through various types of accounting and financial fraud). Since IAS/ISFR provide greater freedom to managers in terms of the way information will be presented in financial statements, our research mainly focuses on the financial statements of entities whose accounting and reporting is based on IAS/ISFR[1]. Furthermore, this research work does not deal with the motives and interests of a third party involved in the information exchange process, namely, the representatives of the accounting profession, since the managers of each entity are primarily responsible for the preparation of its financial statements.

1. Qualitative Characteristics of the Information Presented in Financial Statements

Information presented in financial statements should assist users in economic decision-making. To do so, that information needs to possess a number of specific features. According to the general provisions of IAS/ISFR (1989), the four major characteristics of reported information must be understandability, relevance, reliability, and comparability. The Revised Conceptual Framework on Financial Reporting (September 2010) reconsidered issues related to the qualitative characteristics of information presented in financial statements. The most substantial amendments may be summarised as follows[2] (see Fig. 1):

[1] In terms of this, we have mainly referred to foreign literary sources since they provide a more extensive treatment of those issues.
[2] IASB, Conceptual Framework for Financial Reporting, 2010, Available online at: http://www.ifrs.org/News/Press-Releases/Documents/ConceptualFW2010vb.pdf [Accessed: 17.02.2016]

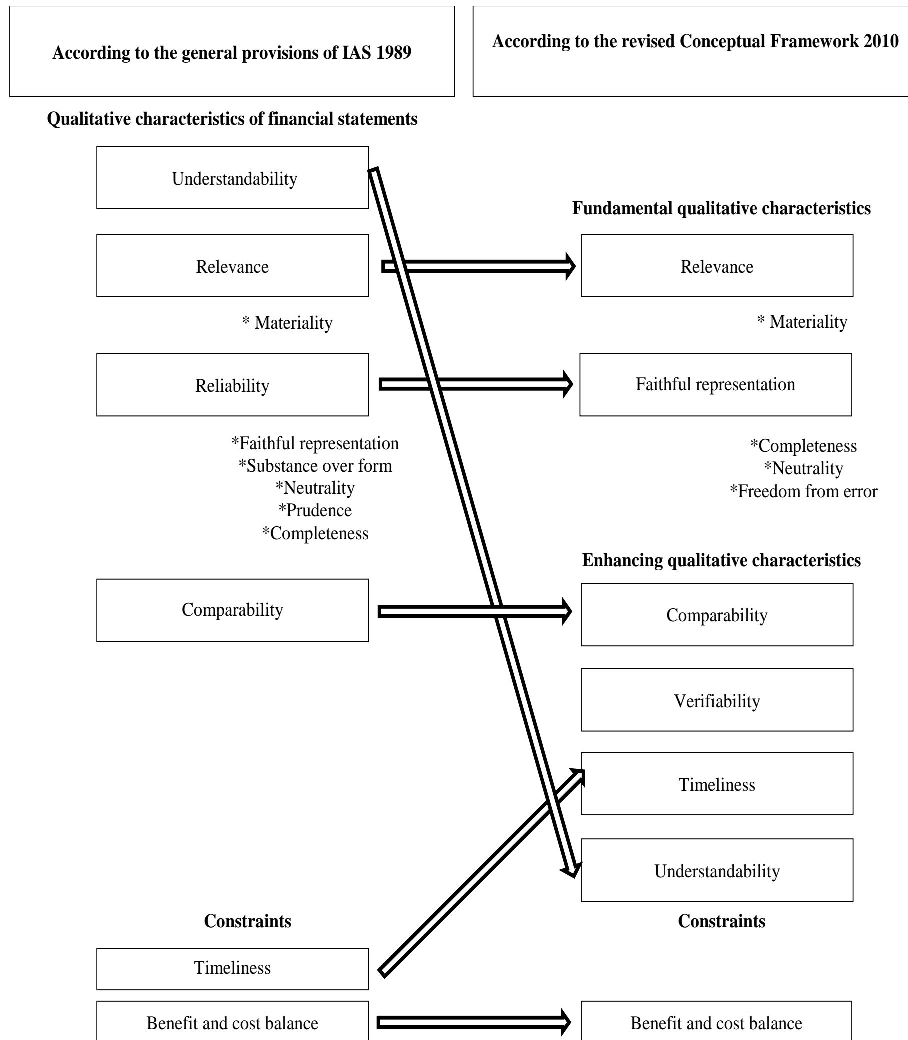

Fig. 1. Qualitative characteristics of financial statements

- two of the qualitative characteristics (relevance and faithful representation) were defined as fundamental ones, while the others were

defined as characteristics enhancing the usefulness of information (comparability, verifiability, timeliness, understandability);

- the term 'reliability' was replaced with the term 'faithful representation', which partially changed its content, too;
- the principle of 'substance over form' is no longer considered a separate component of reliability, as this is perceived to be obvious;
- 'prudence' is no longer considered to be an aspect of faithful representation since it contradicts the principle of neutrality;
- 'verifiability' which had not been explicitly stated as an aspect of reliability before was introduced as a separate enhancing characteristic;
- 'timeliness' was identified as an enhancing characteristic in contrast to the constraint it was formerly considered to be.

The Conceptual Framework for Financial Reporting to IAS/ IFRS (September 2010) identifies two major groups of qualitative characteristics of the information presented in financial statements – fundamental (relevance and faithful representation) and enhancing qualitative characteristics (comparability, verifiability, timeliness, and understandability). **Relevant** information is capable of making a difference in the decisions made by users. It has confirmative and/or predictive value since such information makes it possible to confirm forecasts made earlier and/or predict the future development of an entity. Materiality is an entity-specific aspect of relevance based on the nature or magnitude of the item or the error considered in the particular circumstances. To be useful, information must **faithfully represent** the phenomena it purports to present, which means that it must be complete, neutral, and free from errors.

Enhancing qualitative characteristics add to the fundamental ones and assist the choice of the manner in which a transaction, event or item should be presented when there are different options for presenting them equally reliably and relevantly. The information presented in financial statements is more useful when it is **comparable**, i.e. when it allows users to compare the results of an entity's performance over different reporting periods and identify trends in its development, or compare the performance of different entities. Information is **verifiable** when different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation. **Timeliness** means that information is

available to users in time to assist them in making their decisions. Information should also be presented so as to be **understandable** to users who have at least reasonable knowledge about business and financial reporting and who analyse information with due diligence. Clear and concise classification and presentation of information make it more understandable.

Differences in the interpretation of individual characteristics and changes in their definition and ranking in the Conceptual Framework to IAS/ISFR indicate that those are predominantly perceived subjectively and may only be relatively 'assessed'. Furthermore, due to the intrinsic specifics and constraints of the accounting process, it is often necessary to compromise between individual qualitative characteristics, which gives some freedom to the persons preparing financial statements in their judgment what information they will provide and how they will present it.

2. Financial Statements Users and Their Expectations

The manner in which users of financial statements will perceive the information presented in them primarily depends on their expectations and attitudes, as well as on their accounting and economic knowledge and cognitive capacity which enable them to understand and interpret relevant information more accurately. A reference point for accounting information users is the extent to which they can *trust* the information presented in financial statements. If their expectations in terms of completeness and timeliness are satisfied, they will be under the *impression* that the information is reliable. Another major issue for users of financial statements is their accessibility (that is, they should be published in due time and in full volume). The availability of more exhaustive notes and voluntary disclosures further fosters the impression that entities seek transparency of their actions, which raises users' confidence in the information provided (we should note, however, that additional disclosures for which there are no specific regulations might be misleading). And vice versa, should managers fail to meet users' expectations, provided information will not be positively perceived even if financial statements present the financial position of an entity and its financial results accurately.

Over the last years, the volume of research work focusing on the psychological aspects of economic decision-making has increased. Decision-making is not always a completely rational and objective process, since in the majority of cases it is influenced by the attitudes, perceptions, expectations, objectives, and motives of individual participants. Different users have different expectations – some of them are more conservative and prefer low-risk investment; others consider steady performance over time to be more important; a third group of information users put an emphasis on continuously growing earnings. The 'prospect theory'[3], the 'over-confidence theory'[4], and the 'limited attention theory'[5] are some of the major related theories. According to the limited attention theory, investors have limited attention and information-processing power. Hence, informationally equivalent disclosures may produce different effect on investor perceptions depending on the form of presentation[6].

We could therefore assume that financial statements users would generally have two major types of expectations:

- *expectations in terms of achieved results:*

➢ There will be no serious fluctuations in achieved results, since dramatic changes are indicative of high risk;

➢ Events will be predictable (i.e. expectations will be fulfilled and previous assessments will be confirmed); there will be no unpredicted losses;

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[3] See further **Kahneman**, D., Tversky, A. Prospect theory: an analysis of decision under risk. // Econometrica, 1979, N 47, pp. 263–291and Barberis, N., Huang, M., Santos, J. Prospect theory and asset prices. // Quarterly Journal of Economics, 2001, N 141 (1), pp. 1–53 – according to that theory, people assess differently potential gains and losses and would therefore base their decision-making on information about potential gains, rather than potential losses, even when achieved economic results are the same. This is also known as the 'loss-aversion theory'.

[4] See further **Daniel**, K., Hirshleifer, D., Subrahmanyam, A. Investor psychology and security market under- and over-reactions. // Journal of Finance, 1998, N 53 (6), pp. 1839–1886 – according to that theory, an 'over-confident' investor tends to overestimate the accuracy of private information signals, in contrast to the public signals received by all market players.

[5] **Hirshleifer**, D., Teoh, S. H., Limited attention, information disclosure, and financial reporting. // Journal of Accounting and Economics, 2003, N 36, pp. 337–386

[6] **Ibid**, p. 338.

➢ Achieved results will be positive, even though they may not be very high;

- *expectations in terms of presented information:*

➢ Information will be complete, yet not too extensive or complex;

➢ Information will be presented so that it will be understandable and susceptible to intuitive perception;

➢ Information will be presented in due time and users will be able to trust its reliability;

➢ Presented information will explain any transactions and reporting items which are specific to the entity.

Since the first group of assumptions relate to the sums recognized in financial statements, they could be affected by selecting specific accounting policies or other methods for manipulating accounting information, which are beyond the scope of our research.

As for the second group of assumptions, users will perceive more positively financial statements which:

- Present numerical data in tables understandably and thus make it easy to be compared to the data available for previous periods or other entities;

- Use familiar labels for items and subtotals;

- Provide detailed and specific notes (instead of quoting accounting policies and standards);

- Explain the accounting treatment of items and transactions which are specific to the industry or the entity, especially when the application of different accounting approaches would result in substantial differences in achieved results.

3. Managers and Their Motives

The information to be disclosed in financial statements, as well as the manner in which it will be presented, mainly depend on the goals and motives of managers. Similar to users' expectations, they may be divided into two major groups:

- in terms of achieved results[7]*:*

- Create an idea of a better financial position and higher financial results than the real ones;
- Allocate reserves that will be used to make up for poor results if unfavourable periods are expected in future;
- Avoid reporting negative financial results.

- in terms of presented information:

- Increase the transparency of financial statements to raise users' confidence;
- Alternatively, decrease the transparency of financial statements and omit major facts to conceal unfavourable events, results or trends;
- Provide complicated information which seems to be complete, while its understandability and usefulness are reduced;
- Delay the publishing of financial statements in order to postpone the moment at which users will be informed about certain facts, events, or results.

Another crucial issue is the compromise between short-term and long-term objectives of entities which are often in conflict. Managers may influence not only the measurement and recognition of individual reporting items (an issue which has been left beyond the scope of this paper), but also the way in which recognized assets, liabilities, income, expenses, and financial results will be classified and presented in financial statements. A large part of the practices described above are not in violation of accounting regulations. This means that the threat of sanctions is minimum, therefore such practices are often employed. Nevertheless, they could seriously mislead financial statements users and affect economic decision-making.

4. Conformity In and Contradiction Between the Interests of Participants in the Information Exchange Process

Fig. 2 and Fig. 3 present the goals, motives, and expectations of both parties involved in the exchange of accounting information.

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[7] This research paper does not deal with issues related to the attempt to reduce the tax obligations of entities.

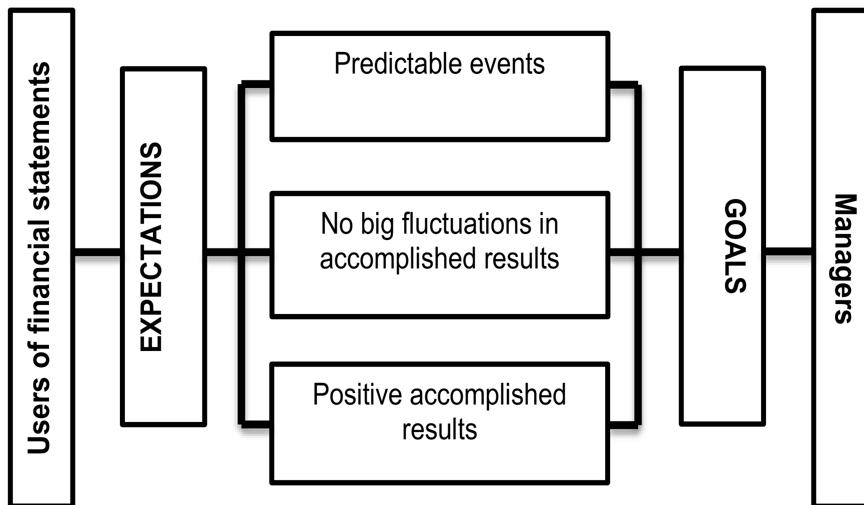

Fig. 2. Conformity between managers' goals and users' expectations

As fig. 2 indicates, in terms of achieved results managers seek to meet the expectations of information users, i.e. there is conformity in the interests of both groups of participants.

When, however, managers are not able to meet these expectations, they tend to employ a number of methods to affect reporting information. Those methods may range from selecting particular accounting policies to making fictitious transactions to present performance results more favourably. Some of the methods relate to the *perception* of the information reported in financial statements, whereas the 'figures' presented in them are not manipulated straightforwardly. While users need reliable, faithful and comparable information to make adequate economic decisions, managers sometimes have no incentive to provide such information. In such cases, the information they provide does not meet users' needs and expectations in terms of completeness, accuracy, or timeliness (see fig. 3).

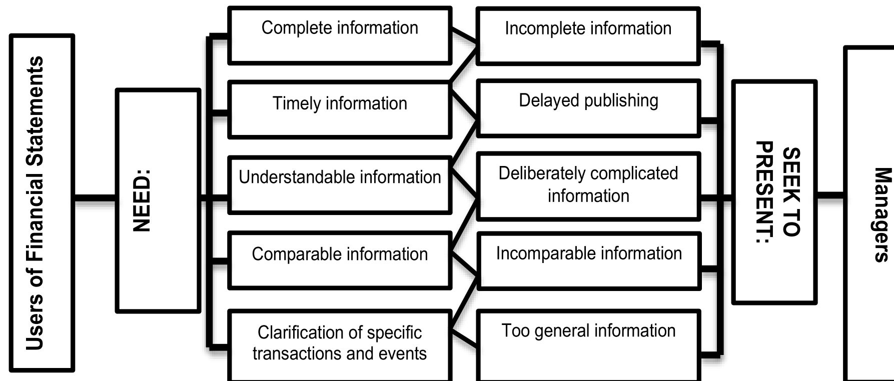

Fig. 3. Conflict between managers' goals and users' needs

In such situations, managers seek to reduce the volume of information which is accessible to users and avoid providing specific information on the accounting treatment of specific transactions and events. They also try to limit the usefulness of the information provided to users by reducing its *timeliness* (i.e. delaying the publishing of financial statements), *understandability* (i.e. deliberately complicating disclosures), and *comparability* (i.e. presenting the information in a form which hinders comparisons to previous periods or other entities). They also employ various methods to affect the manner in which investors and creditors will *perceive* the information presented in financial statements.

5. Methods and Techniques for Manipulating the Perception of Accounting Information

Some of the major manipulation methods which will be considered in this paper include:

- Reduced volume and poor timeliness of financial statements;
- Reduced quality and understandability of financial statements information;
- Reduced comparability of financial statements information;
- Manipulation of the structure of individual statements and the classification of their elements.

These methods do not violate reporting regulations and therefore pose no threat of legal pursuit although they could influence the decision-making process of information users. The specific techniques for employing these methods are presented in fig. 4 and discussed further in the paper.

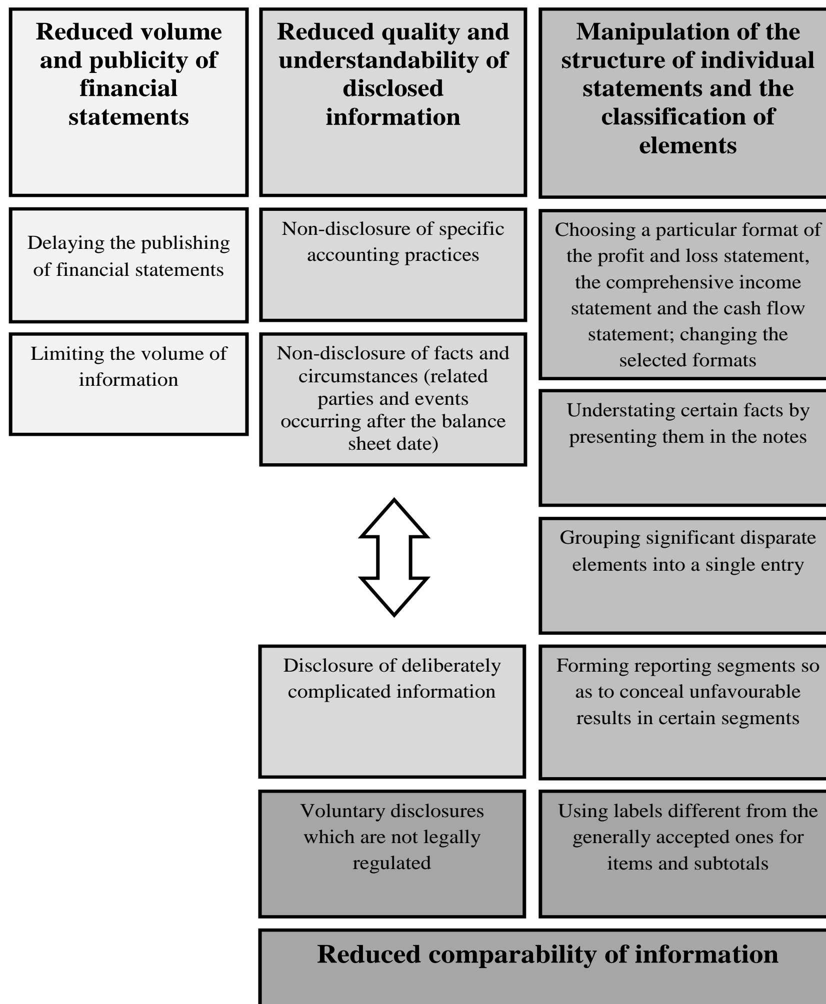

Fig. 4. Methods and techniques for manipulating the perception of accounting information

In the first place, we should point out that financial information is especially useful when it is provided in due time. Entities sometimes deliberately fail to publish their financial statements within statutory regulated deadlines, thus depriving users of the possibility to react promptly and to make adequate economic decisions. Another issue which raises doubts about the quality of information presented in financial statements is the 'quantity' of information itself, i.e. its volume, including that of narrative disclosures. Disclosing a limited volume of information in the accompanying notes is one way of concealing various unfavourable facts. Another important issue is the failure to disclose properly the specific accounting policy employed by the entity to calculate the values of particular indexes. In most cases, non-disclosure of information about a particular type of operations or reporting items indicates that the entity does not possess them or does not engage in similar transactions. Nevertheless, when those transactions are intrinsic of the industry or the entity is known to possess such reporting items, financial information users will expect information about them and non-disclosure will be approached negatively.

Some specific examples of significant recognition omissions include non-disclosure of events after the balance-sheet date; related parties and transactions conducted with them; and contingent liabilities. Transactions with related parties are often made under conditions different from the market ones; furthermore, related parties may exercise control or significant influence upon the business of an entity. Therefore, such relationships might affect performance results even when no transactions are conducted with them. Those specific features also make entities reluctant to disclose such 'sensitive' information. As for non-adjusting events after the balance-sheet date, entities should only disclose significant ones which could affect the economic decisions of financial statement users. It is the discretion of managers, though, whether an event is significant, i.e. they decide if certain events shall or shall not be disclosed.

The issue about the quality of disclosed information is largely a psychological one, since users instinctively perceive narrow-scope disclosures as willingness to conceal unfavourable facts or insufficient effort put into the preparation of a more detailed and complete (in all material aspects) financial statement. Confidence in the quality of provided infor-

mation is usually higher when an entity is considered to have adopted a policy of transparancy in its actions. The issue, however, should not be approached unequivocally. Sometimes financial statements might be deliberately complicated to prevent users from perceiving the real position or development of an entity. As Congressman John Dingell commented on the Enron Scandal, 'What we are looking at here is an example of superbly complex financial reports. They didn't have to lie. All they had to do was to obfuscate it with sheer complexity – although they probably lied, too.[8]' Furthermore, voluntary provision of additional information on behalf of the entity might be misleading, since the content of such disclosures and the manner in which indexes are calculated are not subject to legal regulations. In addition, such information does not have any further usefulness to users, since it cannot be used in comparisons, because other entities do not disclose it.

Information provided in financial statements is less useful when items and subtotals are labelled differently than what is generally accepted, as this reduces comparability. Since IAS/IFRS do not prescribe a specific format or sequence for reporting items, entities are granted the discretion to select those items and subtotals which present most accurately and honestly their financial position and performance. This, however, enables them to present information in a manner which reduces its comparability. When individual items in the major components of the financial statements are not further explained in the notes, the relevance of the information will be significantly reduced. The use of subtotals different from the generally accepted ones renders subsequent analysis more difficult and accounting information users have to recalculate themselves the indexes they need, which cannot always be done accurately unless some additional information is available. Comparability of information about different entities, including entities operating in different industries, may be enhanced by employing statutory formats for financial statements, as the practice in

[8] **McLean**, B. Varchaver, N., Helyar, J. Revell, J., Sung, J. Why Enron Went Bust Start with arrogance. Add greed, deceit, and financial chicanery. What do you get? A company that wasn't what it was cracked up to be. // Fortune Magazine, 2001 [Online] Available from http://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/24/315319/index.htm [Accessed 13 Nov. 2015]

Bulgaria has been. This would also reduce the risk of deliberately manipulating accounting information, since managers would have less discretion on the manner of presenting information. In addition, users who are aware of those statutory formats will understand the contents of the financial statement easier. On the other hand, a single statutory form for financial statements would make it impossible for entities with specific operations or specific reporting units to report them in the most appropriate manner.

The choice of a particular format for presenting individual components in the financial statement may also be employed to manipulate the perception of information. In terms of the statement of profit and loss and other comprehensive income, entities may choose between two approaches to reporting costs – the 'nature of expense' method and the 'cost of sales' method.

In terms of the statement of profit and loss and the other comprehensive income, entities are free to choose between two approaches for reporting expenses – the 'nature of expenses' method and the 'cost of sales' method. The latter requires entities to present expenses according to their function. It provides a bigger volume of significant information to users, since, on the one hand, it revelas the share of expenses in the cost of goods and services sold, and on the other hand, it reveals the costs made to manage and sell those goods and services. The 'cost of sales' approach provides an additional index of the amount of earnings – gross earnings, as the difference between sales revenue and cost of sales. Furthermore, if an entity chooses to apply this method to present expenses in the statement of profit and loss and the other comprehensive income, according to IAS1, Presentation of Financial Statements, it should also disclose further information on the nature of expenses.

Employing the 'nature of expenses' approach enables entities to conceal poor structural ratios between the costs incurred on various activities (for example, large amounts of administrative costs) as their separate disclosure in not statutory. On the other hand, the presentation of costs by function implies significant subjective judgment and may be used to manipulate interim indexes of earnings. Thus for example,[9] classifying a

[9] **Nguyen** K., Financial statement fraud: motives, methods, cases, detection, USA, 2008, p. 31 and **Kwok**, B., Accounting irregularities in financial statements, USA, 2005.

certain expense as administrative, rather than as part of the cost of sales, might result in overstated gross earnings, even though operating profit and net profit indexes will not change. According to a research done by Stolowy and Lebas (2006), there are also various practices in terms of presenting research and development costs: some entities report them on a separate line in the statement of profit and loss and the other comprehensive income, while others report them as cost of sales or admisnistrative costs.[10] Failure to report such costs on a separate line could be justified if their amount is insignificant to the entity and/or these activities are not typical of the particular industry. Their separate reporting is especially important for entities in knowledge-intensive industries, since investments in scientific research and development largely determine the future development of such entities. We should also note that the value of the net earnings index itself is not as important as the values of interim indexes like gross earnings, interim profit, etc. This is due to the fact that the value of net (balance-sheet) earnings is also affected by one-time transactions revenue/expenses which are not expected to occur in near future. Some of the violations in this respect include the classification of revenue from fixed assets sale as operating revenue, as well as the classification of items as recurrent instead of as non-recurrent. Each performance index brings some information to investors and creditors as it covers a different range of revenue and expenses.

Entities may choose between two diferent approaches to preparing the cash flows statement, too. This is the only financial statement whose preparation is not based on the accruals concept and therefore provides to users essential information about real cash inflows and outflows. Entities may employ the direct or the indirect method to report cash flow from operating activities. The advantage of the former is that it enables entities to identify specific revenue from and payments to customers, suppliers, personnel, etc. This approach is also recommended by IAS 7 Statement of Cash Flows and preferred by most creditors and investors.[11] It is more

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[10] **Stolowy** H., Lebas M. Financial Accounting and Reporting: A Global Perspective, Cengage Learning EMEA, 2006, p. 286

[11] **Brahmasrene**, T., Strupeck, C. D., Whitten, D. Examining Preferences in Cash Flow Statement Format. // The CPA Journal. October, 2004, after Abu-Abbas, B., Direct, Indirect, or Both Methods of Reporting Operating Statement of Cash Flows. // International Journal of Finance and Accounting, 2014, N 3(6), pp. 335-340, p. 335.

useful in predicting future cash flows and is compliance with the purpose of preparing *cash flows statements.* Under the indirect method, net earnings are adjusted by a number of non-cash items (depreciation, provisions, etc.), changes in inventories, sums receivable and sums payable, etc. to reach the value of cash flow from operating activities. The advantage of this approach is that it accounts for the difference between financial results and real cash flows. This, in turn, makes it possible to analyse the 'quality' of revenue[12]. The direct method helps provide information on the major groups of cash flows from operating activities which is more useful to users with no background in accounting. In most cases, however, such information could also be reliably obtained through restatement of the information in the cash flows statement prepared under the indirect method. When the issue is manipulation of the **perception** of information (and not manipulation of information itself), adopting either of the approaches might be used to (ostensibly) conceal adverse information, such as major discrepancies between reported revenue and real cash inflows.

Another manipulation method employed by managers is the 'understatement' of certain facts by disclosing them in the notes, instead of recognising them in the main body of the financial statement. Research conducted in the area (Aboody, 1996, and Amir, 1993) gives evidence that investors value more highly the information recognised in financial statements than that announced in notes[13].

Another issue is the grouping of significant heterogenoues elements into a single common item. The omission of significant items of heterogeneous nature or functions (upon the discretion of managers) reduces the usefulness of information since no data is provided on individual units or transactions. Similarly, sums receivable and sums payable must be reported separately and not in compensation for each other.

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[12] **Carslaw**, C. A., Mills, J. R. Including the Cash Flow Statement in Financial Analysis. // Executive Accountant, 1991, pp. 14-16, after Abu-Abbas, Bassam, op.cit., p. 336.

[13] See further **Aboody**, D. Recognition versus disclosure in the oil and gas industry. // Journal of Accounting Research, 1996, N 34, p. 21–32 and Amir, E. The market valuation of accounting information: the case of postretirement benefits other than pensions. // Accounting Review, 1993, N 68 (4), pp.703–724, after Hirshleifer, D, Teoh, S. H, op.cit., p. 344.

Segment reporting may also be employed as a tool for manipulating information. It is of vital importance to users to know which segments are profitable and which are not. According to Hurtt, Lail and MacGregor[14], segment manipulation is a form of ‘classification smoothing’ in which the performance of a subset of a reporting unit is distorted at the expense of (or to the benefit of) another subset. Since current segment reporting requirements grant managers significant discretion, segment reporting may be used to conceal unfavourable results – for example, by grouping an unprofitable operating segment with a profitable one; by presenting an operation as a separate segment, or by including various costs in the general category ‘corporate governance’ instead of reporting them in the segments which they actually refer to.

As for the entities applying IAS/IFRS for the first time, examples of information manipulation include concealing corrections of significant errors by presenting them with the other effects from the transition to IAS/IFRS and non-disclosure of the effect which that transition has had on individual reporting units.

Conclusion

The way in which certain information will be perceived depends both on its presentation and the specific features and attitudes of the entities perceiving it. Therefore, this paper outlined the motives of managers and the expectations and constraints of accounting information users in addition to some major methods for manipulating the perception of information. Some of the most frequently employed methods include: deliberately choosing a particular format for the cash flows statement and the profit and loss statement to conceal negative results; presenting information which is not understandable or comparable enough by labelling

[14] **Hurtt**, D., Lail B., MacGregor, J. The Relationship Between Segment-Level Manipulations And Audit Fees. // The Journal of Applied Business Research – July/August 2013, Vol. 29, N. 4 Available online at: http://www.cluteinstitute.com/ojs/index.php/JABR/article/viewFile/7930/7987 [Accessed 18.Dec. 2015].

items and subtotal with titles other than those which are generally approved; failure to provide sufficient information on specific transactions and events or presenting standard accounting policies texts straightforwardly; understatement of transactions and events by only presenting them in the narrative notes; manipulation of segment-level results. The aim is to bring these methods to the attention of accounting information users since such instances of manipulation generally fit well within the framework of accounting regulations. By being aware of the goals and motives of managers and the approaches they employ, financial statement users would be able to make more rational judgments and take more adequate economic decisions.

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BUSINESS management

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WE ARE PRESENTING THE SLOVAK AUTHOR STEFAN KASSAY AND HIS BOOK OF FIVE VOLUMES “ENTERPRISE AND ENTERPRENEURSHIP”
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