Financial statements: accuracy and reliability

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Introduction

Financial statements are records of a business' revenues/expenses and assets/liabilities. These statements are used by stakeholders to get an idea of the performance and state of affairs of an organisation over a period of time. The stakeholders of a company include its shareholders, tax authorities, banks, regulators, suppliers, customers and employees may also be interested in the financial statements. The important question is: *What do stakeholders expect from financial statements in terms of qualitative characteristics?* An immediate answer depends on the stakeholder and the information he/she is interested in. For example, a shareholder would expect to know about the future prospects of the company while a creditor will be interested in the existing solvency of the company.

Despite these variations in expectations, two characteristics everyone expects from the information in financial statements are accuracy and reliability. Therefore, all measures need to be taken to ensure that the financial statements are accurate and reliable.

What is Accuracy and Reliability of Financial Statements

' Accuracy' and ' Reliability' may mean different things to different people. Some seem to equate accuracy and reliability with precision while others view it principally in terms of verifiability. Financial information is accurate and reliable when it is free from material error and bias and can be depended upon by the users to represent faithfully in terms of valid description which it is reasonably expected to represent. For example, the representation of receivables in a balance sheet at a specified amount, net

of any allowance for bad debts, contends that the stated amount is collectible. However, if the allowance is too small and many more of the receivables are uncollectible, that depiction would not be accurate or reliable because it would not be a faithful representation of the amount that is collectible.

Financial statements should faithfully represent real-world economic phenomena and changes in them. A good example could be the concept of *fair value* . Representations of fair values should change when the values change and the changes should reflect the degree of volatility in these changes.

In addition, information is accurate and reliable only if it is complete. An omission can cause information to be false or misleading.

Presentation of Accurate and Reliable Information in Financial Statements

Accurate and reliable information is accounted for and presented in accordance with its substance and economic reality and not merely its legal form. Reliable and accurate information is neutral, that is, information isNOTselected or presented in a way as to influence the making of a decision or judgement in order to achieve a predetermined outcome.

Accuracy and reliability is affected by uncertainties associated with items recognised and measured in financial statements. These uncertainties are dealt with, in part, by disclosure and, in part, by exercising prudence in preparing financial statements. Prudence can only be exercised within the context of the other qualitative characteristics in the accounting framework,

particularly relevance and the faithful representation of transactions in financial statements. Prudence does not justify deliberate overstatement of liabilities or expenses or deliberate understatement of assets or income, because the financial statements would not be neutral and, therefore, not have the quality of accuracy or reliability.

In order to ensure that financial statements give accurate and reliable information, these are governed by regulations. Regulations are meant to harmonise financial statement preparation in a way that they give a true and fair view of the state of affairs.

How Financial Statements are Regulated to Ensure Accuracy and Reliability

Financial statements are governed by the requirements of companies' legislation and pronouncements of professional accountancy bodies and local accounting standards. These directives and pronouncements/standards are meant to ensure accuracy and reliability of financial statements. Regulators apply rules for controlling how an operator reports its financial results. Preparers of accounts have to incorporate disclosures to bring in more clarity. Therefore, regulations prevent preparers of accounts from exercising much discretion in deciding on the accounting treatment of many of the major items in the accounts.

Accounting regulations assure the integrity of financial statements and provide accurate records for by identifying assets and asset values, earnings, benchmarking, monitoring performance on investment and transparency for investors.

Company Law Directives

In the European Union (EU), the most important company law directive from an accounting point of view that ensures presentation of accurate and reliable financial statements is the EU Fourth Company Law Directives on annual accounts. Incorporation of the requirements of the Fourth Directive has had a significant impact on the presentation of the income statement and balance sheet in particular by prescribing formats and on the disclosures made therein. With the set formats and disclosures, these directives attempt to ensure accuracy and reliability. The requirement that accounts give a true and fair view comes from legislation. True and fair view can only happen when the information in accurate and reliable.

Accounting Standards

Compliance with accounting standards is generally necessary if financial statements are to give a true and fair view. Accounting standards are authoritative statements of accounting practice on how particular transactions/events should be reflected in financial statements. They aim to reduce the variety of practices in the accounting treatment of the matters with which they deal. Implementation of standards has some legal backing in the UK. The authority of the standards derives from the fact that they represent the views of the accounting profession on the appropriate treatment of particular items if accounts are to give a true and fair view.

Accounting pronouncements show a direction where creative interpretations or variations in accounting practices could be inconsistent with the harmonisation objective. There are professional accounting requirements in Financial Reporting Standards (FRSs), Statements of Standard Accounting

Practice (SSAPs) and International Accounting Standards (IASs) of the International Accounting Standards Board (IASB).

The IASB's *Framework for the Preparation and Presentation of Financial Statements* describes the basic concepts by which financial statements are prepared. This framework serves as a guide to the Board in developing accounting standards and as a guide to resolving accounting issues that are not addressed directly in an IAS or IFRS or interpretation. The IASB and the Financial Accounting Standards Board (FASB) emphasize on qualitative characteristics of accuracy and reliability as being one of the key characteristics of financial reporting.

The FASB has *Concepts Statement No 2* , *Qualitative Characteristics of Accounting Information* to refer to, while the IASB has a framework to understand what the components of accuracy and reliability are. The Concepts Statement identifies as its components representational faithfulness, verifiability, neutrality, completeness and freedom from bias. Similarly, IASB framework identifies substance over form, neutrality, prudence and completeness as the components. Both Boards assert that accuracy/reliability and relevance are the key components in presenting decision-useful information to users of financial statements.

Preparers of accountants are guided by the accounting standards or interpretation statements. In the absence of one, management uses its judgement in developing and applying an accounting policy that results in information that is relevant, accurate and reliable. In making that judgement, IAS 8. 11 requires management to consider the definitions, recognition

criteria, and measurement concepts for assets, liabilities, income, and expenses in the Accounting Framework.

FRS18 also clarifies the legal disclosure requirements as *particulars of any departure, reasons for it and its effect*

Sarbanes Oxley Act 2002

US based companies and non-US international companies are subject to Sarbanes Oxley Act. The Act introduces more transparency and accountability into the financial management process and also aims at presenting accurate and reliable financial statements. The Act was introduced in 2002 in the US following accounting and financial scandals in the US. The Act has a stated objective to “ *protect investors by improving the accuracy and reliability of corporate disclosures made* .”

Two main requirements of the act that ensure accuracy and reliability of financial information:

Section 302: Certification of Financial Reports

Section 302 requires that financial statements be complete and accurate. To ensure this, the Act makes Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) accountable for the accuracy and reliability of financial statements. The CEO, CFO and an attesting public accounting firm must certify the accuracy of financial statements and disclosures in the periodic report, and that those statements fairly present in all material aspects the operations and financial condition of the issuer.

Section 302 prescribes criminal penalties if CEOs or CFOs knowingly or willfully issue inaccurate statements. Section 302 also requires that material information that is used to generate periodic reports be retained and available to the public.

In most enterprises, information technology systems generate periodic reports and control tools for communicating this information internally. Chief Information Officers (CIOs) are being asked to ensure that these systems are secure and reliable. Because of the criminal penalties, CIOs also sign an internal attestation on their systems to further protect the enterprise in case of CIO negligence in maintaining these systems.

Section 404 – Management assessment of internal controls over financial reporting

The Act also requires that companies verify that their financial-reporting systems have the proper controls, such as ensuring that revenue is recognized correctly. The Act requires all financial reports to include an internal control report. This is designed to show that not only are the company's financial data accurate, but the company has confidence in them because adequate controls are in place to safeguard financial data.

Ensuring Accuracy and Reliability through Financial Audits

Accounting regulations require statutory independent financial audits for ensuring compliance to regulatory requirements. A financial audit is an audit of financial statements. It involves an independent examination by a third party of the financial statements of a company or any other legal entity resulting in the publication of an independent opinion on whether or not the

financial statements are reliable, accurate, complete and fairly presented and in accordance with accounting requirements. An audit is designed to reduce the possibility of material misstatement (deliberate or otherwise)

In the UK, financial audits are conducted by the Registered Auditors including Chartered Certified Accountant (ACCA) and Chartered Accountant (CA or ACA). They provide *reasonable assurance* that the financial statements are free from material misstatement and give a true and fair view of the state of the company's affairs and its income/loss. It also ensures that the financial statements have been properly prepared in accordance with the Companies Act 1985 or other relevant legislation.

Effectiveness of Regulations in Ensuring Accuracy and Reliability

Despite the exhaustive accounting regulations and requirements of enhanced disclosures common concerns remain about the accuracy and reliability of financial statements. Some regulations such Section 404 of Sarbanes Oxley Act help in improving internal controls and therefore help sounder financial reporting by reporting more accurate and reliable information. The restrictions and penalties for misstatement of financial information, the Sarbanes Oxley legislation has made the communication of financial information by companies much more transparent. However, many stakeholders are unsure about the effect Sarbanes-Oxley has had on communication transparency, suggesting that many may not have an understanding of this legislation and its impact on businesses today.

Regulations can be effective in ensuring accuracy and reliability of financial statements only if regulatory compliance can be guaranteed. Regulatory compliance can only be verified through financial audits but cannot be guaranteed as financial audits have their own limitations.

The auditors follow the rules, but those rules are not always effective at uncovering information that is purposely disguised by a dishonest employee. In addition, auditors utilize sampling techniques to test certain transactions during the performance of an audit or review, since it would be nearly impossible and too expensive to test every single transaction. The sampling may be aimed at the largest items or the items on the financial statements that pose the most risk of misstatement. If material errors in the financial statements are discovered, the auditors will direct management to correct them.

Misstatements can be caused by either error or fraud. Auditors have some responsibility for the detection of both errors and frauds that are material, but this responsibility is not absolute. Auditors give reasonable assurance that material misstatements have been uncovered, but not total assurance.

Errors are much more likely to be discovered during an audit than are fraud. Fraud schemes manipulate the accounting system and controls, and therefore it is more difficult for an auditor to find them. In fact, auditors may never detect immaterial frauds. If a fraud is not large enough to make a difference in the financial statements, then it stands to reason that it most likely will not be detected. This will lead to inaccurate and unreliable financial information in the financial statements.

Besides limitations of financial audits, at times accounting standards themselves may pose limitations. Accounting standards are too slow in addressing a number of controversial and at times are too complex. So too are the financial transactions and structures to which they apply. In fact the existing accounting theory shows lot of resistance to change. Also, it is impossible to accurately describe the financial position of a business enterprise using traditional financial statements. The existing accounting standards offer possibilities of manipulation and window dressing of financial statements. This implies that the financial statements are not completely accurate and reliable.

Also, there may be a need for a trade-off between qualitative characteristics prescribed by accounting standards. For example, FASB Concept statement 2 states that, to be useful, financial information must be relevant as well as accurate / reliable and acknowledges that information may possess both characteristics to varying degrees. However, the accounting framework states constraints on information being both relevant and reliable in terms of timeliness. To be relevant information has to be reported without undue delay. This will impair reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little relevance to users. Similarly, the balance between benefit and cost of reporting financial statement information is also one constraint on relevant and reliable information.

Conclusion

In conclusion, financial statements may not be completely reliable and accurate and even the most meticulously prepared statement may not give

a true, fair view of a business's financial health. Though accounting regulations are important for financial statements to be accurate and reliable, it is equally important to ensure compliance to regulations. Accounting regulations have not been able to completely ensure accuracy and reliability of financial statements as there is still scope of some subjectivity in interpretation of regulations. Financial audits too do not give total assurance. One also needs to be mindful of the trade-offs and the unintended consequences.

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