

Ways of Assets Value Misstatement That Companies Use When Making Financial Statements

L.I. Kulikova, F.N. Akhmedzyanova and A.V. Ivanovskaya
Kazan Federal University, 420008 Kazan, Russia

Abstract: In this study, there are investigation of assets value misstatement ways that companies use in order to gain specific indication in financial statement. The classification of that ways according to misstatement formation technique was proposed. Also, the group of methods was picked out, connected with violation of requirements to assets value evaluation, operations falsification, manipulating requirements to drawing up the consolidated financial statements. Using of such methods came forward in terms of main asset item of companies. The research gives an opportunity to make more detailed planning and validation of the financial statements in the course of the audit.

Key words: Misstatement, assets, accounting, IFRS, financial statements

INTRODUCTION

Today companies often use different methods of assets value misstatement in order to influence the financial results over the accounting period and financial status to accounting date.

Assets value misstatement may be held using different methods of evaluation. And how this evaluation affects the financial situation and distorts the financial statements determine which method are better to use. In addition to the selection of insufficiently substantiated accounting methods while forming an accounting policy with the aim to deliberate distortion of the financial statements, companies often resort to direct violation of the requirements of International Financial Reporting Standards.

The aim of the research is to find and classify methods of assets value misstatement in financial

statements, to define approaches of finding those misstatements over the auditing the financial statements.

MATERIALS AND METHODS

Many researchers had written about the financial statements distortion problem including (Aris *et al.*, 2015; Arzhenovskiy and Bakhteev, 2015; Hasnan *et al.*, 2014; Zhu and Gao, 2011). The analysis of papers and activities of some companies let us detach main methods of assets value misstatement in financial statement (Fig. 1):

- Violation of IFRS requirements in the formation of cost of assets
- Violation of IFRS requirements for the subsequent valuation of assets

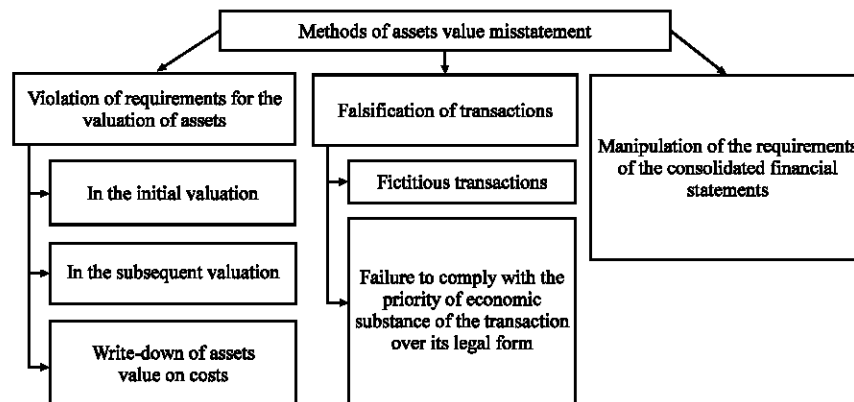


Fig. 1: Methods of assets value misstatement in the financial statement

- Manipulation with methods of assets write-down at cost in order to reach predetermined value of the financial result and the valuation of assets in the statement of financial position
- Recording fictitious transactions
- Failure to comply with the principle of the priority of economic substance of the transaction over its legal form
- Manipulation of the consolidated financial statements requirements

Next, examine the possibility of the above methods usage of the distortion value of assets in relation to certain types of assets. The main method used in this study is the comparison method, the methods of analysis and synthesis.

RESULTS AND DISCUSSION

According to IAS 2 “Inventories” inventories should be valued at the lower of cost and net realizable value without failure. In practice, it can be the situation when the cost of inventories may not be recoverable. The reasons may be damage, complete or partial obsolescence, reduction in the selling price of stocks, the possible increase in the cost of completion of the production process, increasing the potential costs to sell stocks. In such circumstances, stocks should be valued at the lower cost-probable net realizable value and impairment loss inventories should be recognized as an expense of the current period (Kulikova *et al.*, 2015a). However, companies often deliberately refuse to recognize an impairment loss inventories, thereby overstating assets and income for the period.

Another tool of stocks overvaluation in the statement of financial position is the neglect of IAS 2 “Inventories” requirements in respect of the formation of the cost of inventories. Thus, in the cost of inventories cannot be included the above-limit operating costs, the cost of storing inventory, not due to the production process, administrative overhead and selling costs. Sometimes, companies ignore the rules and include the above costs in the cost of inventories, thereby falsify their reports.

It should be noted that since 2005, the International Financial Reporting Standards does not provide for the use of LIFO as a method of valuation of inventories which are expensed in the production or other disposal. However, for the purpose of falsifying financial statement individual companies are using in fact the LIFO method in the evaluation of stocks that in terms of inflation leads to an underestimation of the value of assets and the amount of profit.

Another way of inventory cost distortion is manipulation of indicator of their actual physical size. Usually schemes of the inventory amount distortion are based on forged documents such as inventory reports, invoices. If the company installs an automated inventory recording system, then there are cases where distortions was deliberately laid at the program level.

One option for falsifying of the financial statement is the distortion of the value of receivables, which is often correlated with the distortion of both: amount of revenue and value of stocks. Basic techniques of receivables distortion is the inclusion of fictitious receivables and debts unreal to collect within the receivable or understating the amount of provision for doubtful accounts (Kulikova *et al.*, 2015b).

Fictitious accounts receivable, as a rule, is the result of the fictitious revenue recognition. Such schemes are common among companies that experience financial difficulties, or when their fee depends on the amount of sales revenue. Fictitious accounts receivable is recognized more often towards the end of the reporting period, as a recording of the outstanding receivables in the statement of financial position for a longer period may result in the need for receivables write-off or reserves for doubtful debts (Milbradt, 2012). In order to prevent detection of these schemes and the audited accounts receivable balances at the end of the period the false addresses of debtor companies are used. Thus, receiving confirmation from the debtor about a bogus debt balance, auditors may be misled about the reliability of such residue.

According to the Accounting and Auditing Enforcement Release No. 2190 dated February 17, 2005 as a result of manipulating of the inventories value and accounts receivable for the 5 years period Symbol Technologies, Inc. managed to inflate revenue by 230 million. dollars and pre-tax profit-to 530 million. dollars, for which the company was fined \$ 37 mln. dollars.

The distortion of the fixed assets cost is performed by registration of fictitious assets. Companies whether recognize assets documentarily with virtual absence or enter into contracts for the lease of assets for the period of the audit, without revealing that assets are leased and are not owned by companies under the right of ownership.

By the Litigation Release No. 1893 of October 21, 2004, it's clear that there was the manipulation of the fixed assets value by Qwest Communications International Inc. The investigation of the securities and exchange commission showed that the company booked fictitious fixed assets on the balance including income from sale those fixed assets to the sales revenue. As a result of the

falsification the Qwest Communications International Inc. company overstated the amount of revenue to 3.8 billion dollars.

The distortion of the both assets and liabilities structure is made in violation of the requirements for accounting of leasing transactions. Professional analysts and auditors treat financial leasing as an acquisition of fixed assets under the terms of long-term debt financing. This approach is being laid to IAS 17 “Leases” as well.

The treatment of leasing as an off-balance sheet financing transaction for the tenant is typical for economic and tax laws of most countries including Russia. Some companies prefer to take the financial lease into account as an operating, thereby concealing the sources of funding and providing low level of financial leverage, having good reputation in obtaining credit, increasing the return on capital employed.

However, such an interpretation can lead to significant errors of the financial statements users of the tenant in the analysis of its financial condition. Off-balance sheet funding led to bankruptcy of Great Britain’s large company “Court Line Group of Companies” in the early 70s of 20th century. Tour operator and shipbuilding company went bankrupt. During the liquidation of the company, it was found that the group has entered into a multi-million long-term non-cancellable contracts on leasing several aircrafts that were not reflected in the company’s balance sheet that made reducing of their commitments.

It should be noted that IAS 17 provides no quantitative criteria for assigning the lease to a financial leasing, as opposed to the generally accepted accounting principles of USA which establish that for the classification of the lease to the financial leasing is necessary that the term of the lease was >75% of the asset life and the present value of the minimum lease payments at the inception of the lease was >90% of the fair value of the leased asset (Liapis and Christodouloupoulou, 2011). Classification of the lease in accordance with IAS 17 is based primarily on the professional judgment of an accountant (Vetoshkina and Tukhvatullin, 2014).

External benefits of using quantitative thresholds for the classification of the lease are obvious-it is the objectivity and accuracy. However, the numerical criteria allows tenants to structure leasing papers so that they do not fit within the quantitative indicators for the classification of the operation as a finance lease. The use of such criteria could significantly reduce the degree of subjectivity of an accountant but at the same time it provides an opportunity for off-balance sheet financing, the formation of misleading and biased reports.

Table 1: Detail of the balance sheet of JSC “Aviation Company” Transaero “as of 31.12.2014 (thous. rub.)

Assets	To 12/31/2014	To 12/31/2013
Non-current assets	61,207,880	2,140,155
Intangible assets		
Fixed assets	12,658,216	13,212,860
Financial investments	1,619,356	2,932,722
Deferred tax assets	452,388	117,189
Other noncurrent assets	31,928,539	26,860,167
Total non-current assets	107,866,379	45,263,093

Since, the acquisition of fixed assets associated with significant capital costs and the international standards permitted to capitalize costs directly related to the acquisition of the asset (interest on debt, the cost of shipping, etc.) companies often resort to capitalization of similar items which are not related to acquisition of fixed assets. As an example, the capitalization of interest on borrowed funds that aren’t actually used in the purchase of non-current assets. As a result, these actions lead to overstated value of the asset, overstated profits of this year, understated income in future years.

In the context of fixed asset useful lives of subjective assessments, their residual values, pattern of consumption of economic benefits from the object which are the basis for depreciation of fixed assets, there may be distorted indicators of value that are recorded in the financial statements of companies.

One way of falsifying financial statements is incorrect revaluation of property, plant and equipment and intangible assets, depending on the objectives pursued revaluation. In some cases, companies make re-evaluation of fixed assets, deliberately increasing their value, for example data transfer of objects in escrow in order to obtain a loan capital or, if necessary, increase the value of net assets. In addition, by increasing the value of fixed assets there appears revaluation reserve which can be used to artificially increase of the authorized capital of the company.

An illustrative example of fraudulent financial reporting that is result of an artificial revaluation of intangible assets is a statement of JSC “Aviation Company” Transaero” for 2014, prepared in accordance with Russian Accounting Standards (Table 1).

As shown in Table 1, to 12/31/2014 under “Intangible assets” JSC “Aviation Company” Transaero” increased the value of the trademark compared with 2013 year by about 30 times, in connection with which there was an increase of net assets.

In accordance with the Russian accounting standards, the commercial organization has the right to revalue the groups of homogenous intangible assets at current market value which should be determined only according to the active market for these assets. In the

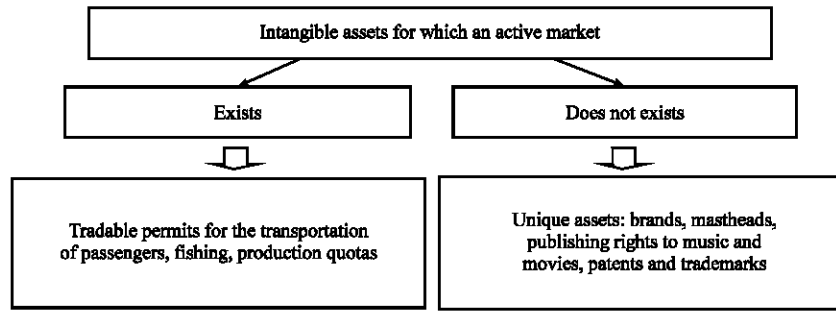


Fig. 2: The presence of an active market of intangible assets

Russian standards the concept of an active market is not disclosed, so it is necessary to apply the provisions of IFRS. In IAS 38 “Intangible Assets” stated that the existence of an active market of intangible assets is a rare, but nevertheless, the possible thing. In IAS 38, there are examples of the existence of an active market for certain types of intangible assets that are presented in Fig. 2.

Thus, IAS 38 specifies that there is no active market of Trade marks as they are unique. During the revaluation of intangible assets such indicators of the financial statements will be distorted.

Manipulation of financial consolidation rules allows companies to achieve different goals. Due to the overvaluation of the Consideration Transferred (CT) on the acquisition of a subsidiary, assess Non-Controlling Interest (NCI) or by understating the value of the acquired Identifiable Net Assets (INA) can be overstated goodwill (G) which is included in the assets and thus increase the balance sheet total. The formula for calculating the goodwill in accordance with IFRS 3 “Business Combinations” is as follows:

$$G = CT + NCI - INA \quad (1)$$

In order to drive up profit in the consolidated financial statements companies may resort to the scheme of “double sales”, selling to a subsidiary product at an inflated price first and then subsidiary sells the goods to the end user. The increase in net income of group (P) of such an operation will be:

$$P = (1 - r) \times (Pm \times Ps + d) \quad (2)$$

Where:

- r = The rate of tax on profits
- d = Ownership interest in a subsidiary
- Pm = The profit of the parent company from selling goods of subsidiary
- Ps = The profit of the subsidiary from selling goods to the end user

In the context of a fixed-price when selling goods to the end user ($Pm + Ps = \text{const.}$) the cause of overestimation of consolidated profit is the decline in consolidated profit attributable to non-controlling interest.

CONCLUSION

The proposed classification of methods of assets value distortion in the statement of financial position helps to determine the most common techniques in relation to the distortion of particular assets value.

Disclosed techniques, actually used by companies to generate pre-defined statement of financial position and statement of profit and loss and other comprehensive income, may serve as a basis for the identification and scrutiny of operations that embody higher risk of formation of false information in the financial statements in the course of the audit. Ultimately, this will enhance the usefulness of financial reporting information provided to users.

REFERENCES

- Aris, N.A., S.M.M. Arif, R. Othman and M.M. Zain, 2015. Fraudulent financial statement detection using statistical techniques: The case of small medium automotive enterprise. *J. Appl. Bus. Res.*, 31: 1469-1478.
- Arzhenovskiy, S. and A. Bakhteev, 2015. Model of integrated estimation of audit risk. *Mediterr. J. Soc. Sci.*, 6: 241-246.
- Hasnan, S., R.A. Rahman and S. Mahenthiran, 2014. Determinants of fraudulent financial reporting: Evidence from Malaysia. *J. Pengurusan*, 42: 103-117.
- Kulikova, L.I., A.Y. Sokolov, A.V. Ivanovskaya and F.N. Akhmedzyanova, 2015a. Lowest value principle implementation in inventory measurement of financial statements of the enterprises. *Mediterr. J. Soc. Sci.*, 6: 406-410.

- Kulikova, L.I., A.G. Garyncev and A.V. Goshunova, 2015b. Doubtful debts allowance development: Stages and methods of calculation. *Mediterr. J. Soc. Sci.*, 6: 448-452.
- Liapis, K.J. and E.P. Christodouloupoulou, 2011. How GAAP and accounting treatments influence property management. *J. Property Investment Finance*, 29: 251-279.
- Milbradt, K., 2012. Level 3 assets: Booking profits and concealing losses. *Rev. Financial Stud.*, 25: 55-95.
- Vetoshkina, E.Y. and R.S. Tukhvatullin, 2014. The problem of accounting for the costs incurred after the initial recognition of an intangible asset. *Mediterr. J. Soc. Sci.*, 5: 52-55.
- Zhu, J. and S.S. Gao, 2011. Fraudulent financial reporting: Corporate behavior of Chinese listed companies. *Accounting Asia*, 11: 61-82.