Errors in applying Accounting Standards that misstate financial reports

Contents

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Misstatement of financial reports

In this article we consider:

- Why entities may misstate financial reports;
- How the misstatement can arise; and
- What issues investors, directors and users of financial statements can look out for which may indicate that a financial report has been misstated.

Why misstate financial reports?

There are three main reasons why financial reports are misstated:

1. To meet stakeholder expectations;
2. For personal benefit (or the benefit of those around them); and
3. Ignorance of applicable accounting standards.

Meeting stakeholder expectations

Many cases of deliberately misstating a financial report arise because the entity needs to meet stakeholder expectations, the stakeholders being:

- Investors and shareholders;
- Financiers and lenders;
- Potential investors; and
- Potential financiers.

Misstatement for personal benefit

Some cases of deliberately misstating a financial report arise for the benefit for an individual:

- To earn a bonus / collect share-based payments;
- To keep an individual in a job;
- To hide a mistake / bad business decision; and
- To fend off potential financial collapse of the entity.

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Financial result manipulation

To overstate the financial performance of an entity (certainly for a single period) is relatively simple and can be broken down into the following main headings:

- Overstate revenue;
- Understate costs;
- Failure to recognise impairment losses on impaired assets;
- Expenses are capitalised as assets;
- Fail to recognise liabilities and expenses; and
- Incorrectly value assets and liabilities.

These errors often occur because management have:

- Made overly optimistic estimates and judgements when applying the accounting standards;
- Entered into complex transactions (which may be with related parties) either without economic substance or deliberately structured to hide the economic substance; or
- Failed to record a transaction or to record the transaction in the wrong period.

Revenue

Since 2018 entities have been required to recognise revenue in accordance accounting standard AASB 15 *Revenue from Contracts with Customers*. This standard places significantly more restrictions on recognising revenue than on the predecessor revenue accounting standards, AASB 118 and AASB 111.

However, it is still possible to overstate revenue, some methods include:

- Recognising revenue 'up front' when the entity has yet to deliver the good or service it is contractually obliged to do so;
- Enter into contracts without economic substance, whereby the entity does not obtain economic benefit from providing the good or the service;
- Recognise revenue when it is not highly probable that consideration will be received;
- Overestimate the percentage of completion on a contract (particularly relevant for revenues earned on construction contracts);
- 'Gross up' revenue to include out of pocket expenses;
- 'Gross up' revenue by excluding marketing monies paid to the customer;
- Recognising revenue when control of the good has not been transferred to the customer; or
- Recognising revenue as a principal rather than as an agent.

Overstate other income

Overstatement of other income can be achieved by:

- Recognise grant income immediately in respect of a capital grant (failure to correctly apply AASB 120);
- Overstate the fair value gain on revalued financial assets (failure to correctly apply AASB 9 and AASB 13); and
- Overstate the fair value gain on an investment property (failure to correctly apply AASB 140 and AASB 13).

Costs and expenses

Understating costs and expenses can be achieved by:

- Not recording costs i.e., keep the invoice in the draw rather than recording it as a liability;
- Fail to recognise provisions for costs that will not become payable in the short term (e.g., long service leave, environmental restoration);
- Not recognise impairment charges (see overstating assets below);
- Incorrectly recognise deferred tax assets;
- Fail to recognise claims against the entity;
- Failure to recognise the cost of share-based payments made to employees (e.g., options issued);
- Failure to recognise the financing costs arising on borrowings including accounting for conversion features in convertible notes;
- Failure to correctly recognise and measure derivative liabilities; and
- Incorrect determination of the fair value of liabilities.

Impairment of assets

The requirement to impair assets is set out in a number of different AASBs depending upon the type of asset being tested for impairment:

- AASB 9 applies to financial assets, including trade debtors and loan receivables;
- AASB 102 applies to inventory; and
- AASB 136 applies to non-current assets such as goodwill, intangible assets, and property plant and equipment.

A material misstatement can occur in respect of impairment of assets by:

- Failing to recognise that an asset should be impaired;
- Being overoptimistic in respect of estimating the cashflows an asset will generate; or
- Capitalising expenses as assets.

Capitalised expenses

Overstatement of an entity’s performance can be achieved by capitalising costs that should have been recognised as an expense, the AASBs that set out what costs can or not be capitalised include:

- AAAB 102 in respects of costs that can be capitalised in inventory;
- ASSB 116 in respect of what can be capitalised in respect of property plant and equipment;
- AASB 138 in respect of what can be capitalised as an intangible asset (noting AASB 138 prohibits the capitalisation of research, training and advertising costs);
- AASB 140 in respect of costs that can be capitalised to investment properties;
- AASB 3 prohibits the costs of acquiring a business to be capitalised; and
- AASB 132 restricts costs that can be capitalised when raising equity or debt.

Fail to recognise liabilities

The performance of an entity can be overstated by simply not recognising or underestimating liabilities.

Methods of understating liabilities include:

- Not recording costs i.e., ‘keep the invoice in the draw’ rather than recording it as a liability at period end;
- Fail to recognise provisions for costs that will not become payable in the short term (e.g., long service leave, environmental restoration);
- Fail to recognise claims against the entity;
- Failure to correctly recognise and measure derivative liabilities; and
- Incorrect determination of the fair value of liabilities.

Fair value measurement

The accounting standards require certain assets and liabilities to be measured at fair value applying the requirements of AASB 13, these being:

- AASB 3, acquired assets and liabilities acquired in a business acquisition are measured at fair value;
- AAAB 9 requires certain financial assets and liabilities to be measured at fair value;
- AASB 140 investment property can be measured a fair value; and
- AASB 141 biological assets must be measured at fair value.

Inappropriately determining the fair value of the relevant asset or liability can lead to overstatement of an entity’s performance.

Fail to make the appropriate classification or presentation

Errors in classification include:

- Wrongly classifying liabilities as non-current when the entity does not have an unconditional right to defer repayment (AASB 101);
- Wrongly classifying a disposal group as held for sale and therefore a current asset (AASB 5);
- Wrongly derecognising a trade receivable that has been factored, but the entity retains the risks associated with that receivable (AASB 9);
- Wrongly classifying operating cash outflows as investing cash outflows (AASB 107);
- Wrongly classifying investing cash inflows as operating cash inflows (AASB 107); and
- Wrongly classifying financing cash inflows as operating cash inflows (AASB 107).

Information material to the understanding of the financial report

The AASBs require various disclosures and particular presentation that are intended to assist the user of financial statements, if the preparer is intending to mislead the users, then omitting disclosure and inappropriate disclosure follow. Areas of inappropriate presentation and disclosure include:

- Omitting disclosure as to material uncertainty that exist in respect of the entity's ability as a going concern (AASB 101);
- Omitting to disclosure information about the assumptions, the entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year can lead to the users of the financial being misinformed (AASB 101);
- Omitting to disclosure the judgements, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements can lead to the users of the financial being misinformed. (AASB 101);
- Omitting to disclose the entity's exposure to credit, liquidity, and market risks (AASB 7).
- Omitting to disclose information in respect of the entity's joint arrangements and associates;
- Omitting to disclose significant subsequent events (AASB 110);
- Omitting to disclose details of the performance the entities segments (AASB 8); and
- Omitting to disclose details of related party transactions (AASB 124).

Accounting Misstatement	Relevant AASB	Financial report error
Revenue from sales of goods and services	AASB 15 and AASB 118 (pre-2018)	Misstatement arises from: • Recognising revenue when control of the good has not be transferred • Recognising revenue when the service has not been provided • Recognising revenue when it is not probable consideration would be received.
Revenue group accounts	AASB 10	Material misstatement can occur by consolidating revenue from 'subsidiaries' which they entity does not control. Failure to equity account entities, where the entity investor does not have the power to control the relevant activity of the investee
Revenue from discontinued operations	AASB 5	Misstatement arises from failing to correctly classify an operation as a discontinued operation
Sale and lease back transactions	AASB 16	Misstatement arises from sale and lease back of assets.
Inventories at cost	AASB 102	Misstatement arises from: • Not offsetting supplier rebates against inventory; • Inflating expected supplier rebates; • Supplier rebates being conditional on future purchases; and • Gross up of rebates and inflated prices for future purchases.

Accounting Misstatement	Relevant AASB	Financial report error
Financial asset valuation	AASB 9	Misstatement arises from: • Recording assets at fair value that should be recorded at amortised cost; and • Incorrectly determining the fair value of an asset (AAASB 13).
Government grants received	AASB 120	Misstatement arises from recognise in income a capital grant for the acquisition of an asset.
Investment properties at fair value	AASB 140	Misstatement arises from: • Recording assets at fair value that should be recorded at amortised cost; and • Incorrectly determining the fair value of an asset (AASB 13).
Biological assets at fair value	AASB 141	Misstatement arises from incorrectly determining the fair value of a biological asset (AASB 13).
Joint arrangements and associates	AASB 11 and AASB 128	Misstatements occur when an entity fair values its investment in accordance with AASB 9 and recognises the increase in fair value in profit or loss rather than correctly applying equity accounting.
Applying acquisition accounting and control	AASB 3	Material errors can arise when an entity incorrectly determines either: • It has gained control of an investee; or • It has lost control of an investee, and incorrectly recognises a gain on these events.

Accounting Misstatement	Relevant AASB	Financial report error
Non-current asset impairment	AAB 136	Misstatement arises from: • Not testing an asset for impairment; • Forecast cashflows used to determine recoverable amount using value in use (VIU) are not reasonable or supportable; • Forecast cashflows used to determine recoverable amount using VIU do not represent asset in its current state; • Discount rate used to determine recoverable amount using VIU does not reflect the risk those cashflows would not be achieved; • The recoverable amount using fair value less cost to sell valuation method does not represent the fair value of the asset. AASB 136 errors often arise when accounting for: • Goodwill; • Intangibles; • Property plant and equipment; and • Investments recorded at cost.

Accounting Misstatement	Relevant AASB	Financial report error
Financial asset impairment	AASB 9	Misstatement arises from: • Not determining there has been a significant deterioration in the credit risk of the counterparty • Incorrectly determining the recoverable amount of the financial asset Applies to: • Trade receivables; • Loans; • Loans to associates; and • Contract assets recognised under AASB 15.
Impairment of inventories	AASB 102	Misstatement arises from incorrectly determining the NRV of inventory.
Exploration and evaluation expenditure	AASB 6	Misstatement arises from: • Capitalise costs in the prospecting phase; and • Capitalise costs when entity does legal ownership of tenement.
Joint arrangements and associates	AASB 128	Misstatement arises from: • Failing to test the investment in the joint arrangement or associate for impairment; and • Failing to determine recoverable amount of the investment in the joint arrangement or associate correctly.

Accounting Misstatement	Relevant AASB	Financial report error
Contractual liabilities	AASB 9	Misstatement arises from: • Not record invoices from suppliers; • Not accrue for goods and services provided by suppliers; • Not record borrowings; and • Not record guarantees provided.
Provisions	AASB 137	Misstatement arises from: • Fail to recognise provision for onerous contract; • Fail to provide for bonuses; • Fail to provide for claims and litigation; • Fail to provide for restoration costs; and • Fail to provide for rehabilitation costs.
Employee benefit obligations	AASB 119	Misstatement arises from: • Not provide for annual leave; • Not provide for long service leave; • Not provide for bonuses; and • Not provide for post-retirement obligations.
Income tax	AASB 112 / Interpretation 23	Misstatement arises from: • Recognising deferred tax assets for carried forward losses when it was not probable the entity would generate taxable profits in the future; and • Not providing for tax obligations in accordance with the applicable tax legislation.

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Accounting Misstatement	Relevant AASB	Financial report error
Convertible and converting debt instruments	AASB 132	Misstatement arises from convertible and converting debt instruments in relation to: • Incorrectly recording a liability as equity; and • Incorrectly recording a derivative liability as equity. Errors usually involve the instrument failing the 'fixed for fixed' test, where it is not known either: • The number of shares the entity will have to issue, or • The quantum of cash the entity will receive.
Omitting liabilities for share-based payments	AASB 2	Misstatement arises from incorrectly determining a share-based payment is equity settled rather than cash settled.
Inventory costs that should be expensed	AASB 102	Misstatement in accounting for inventories arises from: • Capitalising costs that are not part of bringing the inventories to their present location and condition; • Capitalising abnormal amounts of wasted materials, labour, or other production costs; • Capitalising storage costs, unless those costs are necessary in the production process before a further production stage; • Capitalising administrative overheads that do not contribute to bringing inventories to their present location and condition; and • Capitalising selling costs.

Accounting Misstatement	Relevant AASB	Financial report error
Plant and equipment costs that should be expensed	AASB 116	Misstatement in accounting for property, plant and equipment arises from: • Capitalising the costs of the day-to-day servicing of the item; • Capitalising repairs and maintenance; • Capitalising costs of opening a new facility; • Capitalising costs of introducing a new product or service (including costs of advertising and promotional activities); • Capitalising costs of conducting business in a new location or with a new class of customer (including costs of staff training); and • Capitalising administration and other general overhead costs.
Borrowing costs incorrectly capitalised to a qualifying asset	AASB 123	Misstatement of borrowing costs related to qualifying assets arises from: • Capitalising interest when the asset is not being actively developed; and • Capitalising interest when the asset is ready for use.

Accounting Misstatement	Relevant AASB	Financial report error
Incorrectly recognising intangible assets	AASB 138	Misstatement of intangible assets arises from: • Capitalising research costs; • Capitalising costs when it is not it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; • Capitalising costs of introducing a new product or service (including costs of advertising and promotional activities; • Capitalising costs of conducting business in a new location or with a new class of customer (including costs of staff training); and • Capitalising administration and other general overhead costs
Investment property overstatement	AASB 140	Misstatement arises from: • Capitalising start-up costs (unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management); • Capitalising operating losses incurred before the investment property achieves the planned level of occupancy; or • Capitalising abnormal amounts of wasted material, labour or other resources incurred in constructing or developing the property.

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Accounting Misstatement	Relevant AASB	Financial report error
Equity raising costs	AASB 132 / AASB 9	Misstatement arises from: • Incorrectly offsetting costs of equity when the entity has actually issued a derivative liability; and • Incorrectly offsetting costs general overheads (cost of CEO etc) as a cost of equity raising.
Costs of a business combination	AASB 3	Misstatement arises from treating the costs of a business combination as an acquisition cost and allocating those costs to acquired assets.
Foreign exchange	AASB 121	Misstatement arises from: • Wrongly determining an entity's functional currency; • Wrongly changing an entity's functional currency; and • Wrongly treating short term loans and trade payables as part of the net investment in a controlled entity.
Share-based payments	AASB 2	Misstatement arises from: • Failing to recognise a share-based payment; and • Incorrectly calculating the share-based payment.
Factoring arrangements	AASB 9	Entities can enter into debt factoring to improve cashflows and liquidity, however in most situations a debt factoring arrangement should be recorded as a borrowing, with a liability being recorded until the financier receives the cash from the factored debt. Users can be misled as to an entity's liquidity position if no liability is recorded.

Accounting Misstatement	Relevant AASB	Financial report error
Misclassification of current borrowings	AASB 101	A number of litigation matters, (including the Centro case) involve the entity wrongly classifying as non-current borrowings when the terms of the loan or because of breaching loan covenants the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Users wrongly arrive at the conclusion there is no liquidity risk.
Overstating operating cashflows	AASB 107	An entity may overstate its operating cashflows by: • Wrongly classifying operating cash outflows as investing cash outflows (i.e., no asset was created) • Wrongly classifying financing cash inflows (e.g., cash receipts from borrowings) as operating cashflows • Wrongly classifying investing cash inflows (e.g. cash receipts from sale of a business) as operating cashflows.
Discontinued operations	AASB 5	If an entity classifies non-current asset (or disposal group) as held for sale and that disposal group is loss making, it improves the presented results and balance sheet by: • Improving reported results from continuing operations (because the loss-making disposal group is excluded); and • Increasing current assets (the disposal group's non-current assets are classified as a current asset). If the entity is not in a position to classify the disposal group as held for sale, the user of the financial report will have been misled.

Accounting Misstatement	Relevant AASB	Financial report error
Going concern uncertainty	AASB 101	When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity is required to disclose those uncertainties. Failure to do so can significantly mislead the user of the financial report.
Key judgements in applying AASBs	AASB 101	Not disclosing the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements can lead to the users of the financial being misinformed.
Key estimates in applying AASBs	AASB 101	Not disclosing information about the assumptions, the entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year can lead to the users of the financial being misinformed.
Exposure to credit risk	AASB 7	Many litigation matters involve a situation where the entity was adversely impacted by credit risk i.e., a receivable or loan was not collected (credit risk). If AASB 7 had been complied with users of the financial report would have been properly informed of this risk.

Accounting Misstatement	Relevant AASB	Financial report error
Exposure to liquidity risk	AASB 7	Many litigation matters involve a situation where the entity was adversely impacted by liquidity risk i.e., the entity could not pay its trade creditors or repay bank loans. If AASB 7 had been complied with users of the financial report would have been properly informed of this risk.
Exposure to market risk	AASB 7	Litigation matters may involve a situation where the entity was adversely impacted by market risk e.g., the entity was exposed to foreign exchange risk in respect of cash, trade receivables, trade payables or bank borrowing. If AASB 7 had been complied with users of the financial report would have been properly informed of this risk.
Segment information	AASB 8	Failure to disclose disaggregated segment information as set in AASB 8 results in users not being provided with information to evaluate the nature and financial effects of the business activities in which it engages.
Information in respect of Joint Ventures and Associates	AASB 12	Where an accounting failure involves the failure of an entity’s investment another entity (e.g., a joint arrangement or an associate), failure to appropriately disclose information about that entity can lead to the claim that investors were misled or misinformed.

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Accounting Misstatement	Relevant AASB	Financial report error
Subsequent events	AASB 110	Failure to disclose such events as: (a) a major business combination after the reporting period or disposing of a major subsidiary; (b) announcing a plan to discontinue an operation; (c) major purchases of assets, classification of assets as held for sale in accordance with AASB 5 other disposals of assets, or expropriation of major assets by government; (d) the destruction of a major production plant by a fire after the reporting period; (e) announcing, or commencing the implementation of, a major restructuring (f) major ordinary share transactions and potential ordinary share transactions after the reporting period (g) abnormally large changes after the reporting period in asset prices or foreign exchange rates; (h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities); (i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and (j) commencing major litigation arising solely out of events that occurred after the reporting period can lead to the user of the financial report being misinformed.

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The team at Basford Consulting have prepared numerous expert reports for use in court proceedings dealing with the application of accounting and auditing standards. We provide independent expert evidence drawing from our considerable experience in providing technical accounting, auditing, and governance solutions for clients.

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