FINANCIAL REPORTING: HOW RELIABLE AND DEPENDABLE ARE FINANCIAL STATEMENTS?

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Abstract

Recent developments in the business circle such as the loss, users of financial reports sustained by relying on and using financial reports prompted this article. Such developments are the AP Saga, the Enron Corporation incident in the USA and bank distresses witnessed in the recent past. These developments no doubt could render financial reports unreliable and undependable for decision making with the attendant consequences on the economy such as low economic activity and its multiplier effects. We x-rayed the role of various parties responsible for the production and publication of financial reports and established the culpability of each party with bulk of the blame going to the management team. We suggested measures that could minimize the incidence of misinformation in financial reports prominent amongst which are involvement of management in ownership of companies, reorienting corporate managers to imbibe moral and ethical values and working on existing legal and regulatory framework that would deter perpetrators of fraud and other kinds of vices in corporate management. We opined that confidence of users of financial reports could be secured when managers of resources imbibe the virtues of honesty and integrity in corporate governance and until this is assured, users of financial reports should use them with caution.

Introduction

In the recent past, users of financial reports had suffered one form of loss or the other by relying on and using financial statements of the reporting enterprise to take investment decisions. For instance, after the sale of African Petroleum Company (AP) in the on-going privatization exercise of the Federal Government of Nigeria, the core investor and other investors discovered that the former management of AP had concealed the sum of 25.3 billion indebtedness of the company to outsiders from the books. The then Managing Director (2002:2) asserted: "The past management concealed documents which deceived Sadiq Petroleum Nigeria Ltd. To offer W35.63 per share for the Federal Government's share at *$1* 2.31 billion besides non-refundable fees paid for expression of interest[1]' In far away United States of America. Enron Corporation which was ranked ?"' on the fortune 500 companies in that country in 2000 collapsed in a matter of weeks.

Lamenting the aftermath of the bankruptcy of Enron Energy Corporation in the U.S, Abel AIG. Asein (2002, P.28) said:

...Countless shareholders lost their equity investment running into billions of dollars, creditors and financial institutions similarly lost their investments.

In the not-too-distant past, we witnessed the unprecedented distress of banks in Nigeria. This was not long after the certifying authority had issued a clean bill of health on the financial statements of the failed banks.

These three incidents, to mention but a few, are capable of putting the credibility of (he contents of financial reports to question with the attendant negative consequences of rendering such reports unreliable and undependable for the purpose of decision making.

Glautier and Underdown (1976:P.5) underscore the importance of financial reporting to users:

Investors, be they large or small, must be provided with reliable and sufficient information in order to be able to make sufficient investment decisions.

According to them, accounting is not an end in itself. As an information system, the justification for accounting can be found only in how well accounting information serves those who use it.

1'his apparent contradiction of the face value with the real value of the financial performance of companies would worry and bug the mind of users of financial reports and regulatory bodies.

It is therefore against the forgoing that attempt is made in this paper to examine the extent of credibility, reliability, dependability and continued usefulness of financial reports for making rational economic decisions in the face of the challenges posed by the outcome of recent financial reports.

Attempts to make suggestions that could improve financial reporting so as to secure the confidence of users of financial reports were made.

Meaning, Types, Qualities, Users and Uses **of Financial Reports. Meaning**

Financial reports are prepared to show the result of the economic activities of an enterprise or social activities of a non-profit making organization for a given period of time, usually a year.

Forms of Financial Reports

There are different forms of reporting financial information about an enterprise for external use. Section 334 (2) of CAMA lists the following as constituting financial statements (reports): (a) Statement of accounting policies, (b) The balance sheet at the last day of the year, (c) A profit and loss account or, in the case of a company not trading for profit, an income and expenditure account for the year; (d) Notes on the accounts; (e) The Auditors reports; (f) The Director's reports; (g) A statement of source and application of fund now being popularly replaced with cash flow statement; (h) A value added statement for the year; (i) A five year financial summary, the group financial statements

Characteristics of Financial Report

For a corporate report to be useful, it should possess certain characteristics. This is the view of the true blood report, which sets out the characteristics information .contained in corporate reports should possess. These characteristics are: (a) Relevant (b) understandable (c) reliable (d) complete (e) objective (f) Timely (g) Comparable. These form the basis for assessing the worth of a financial report.

Users and Uses **of Financial Reports**

Here users and uses of financial reports are highlighted. (ASSC 1975) identified the following groups as having a reasonable right to information, which should be recognized in corporate reports.

(a) The equity investor group (h) the loan creditor group (e) employee group (d) the analyst -adviser group (e) the business contact group including trade creditors and suppliers (I) The government including tax authorities, (g) the public including the tax payers. rate payers. consumers and other community and special interest groups such as political parties, consumer and environmental protection societies and regional pressure groups

Each group uses accounting report for taking decisions(s) that would serve her peculiar needs.

Parties Responsible for **the** Preparation **and Making** of **Financial Reports**

Below are those responsible for preparing financial statements and performing the attestation function on the financial reports.

Management

It is the responsibility of management of an organization to prepare financial statements because the resources of the owners are entrusted to them to manage and render stewardship report. This role is replete with history. Where external auditors are engaged for prepare financial reports, it would be regarded as a separate and distinct responsibility from their audit assignment and they would be paid for such.

The Internal Auditor

They are to ensure that the way the organization should operate as designed are implemented to the letter. In other words, the internal control and internal cheek of an organization are operated as designed. The internal auditor reports to the head of management team.

The External Auditor

As required by the Companies and Allied Matters Act (1990), the external auditor has the statutory role to examine the financial statements and report that they show a true and fair view of the state of affairs of the entity or to show that they do not. They should report too that the financial statements conformed to the generally accepted accounting principles, other relevant legislation and standards and whether there are errors, misstatements or fraud in those accounts. This attestation function by chartered accountants gives credibility to financial statements prepared by management.

The Audit Committee

The Audit Committees of companies serve as a bridge between the external auditor and the board of directors. Section 359(6) of CAMA 1990 provides that the audit committee should:

- Ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices;
- Review the scope and planning of Audit requirements;
- Keep under review the effectiveness of the company's system of accounting and internal control: etc.

The Audit Committee is therefore to provide a regular check on the activities of the board and management of the company. They are expected to raise audit alarm if need be.

The Directors

They are statutory agents of the organization and, therefore must act in utmost good faith. They are expected to prudently handle the affairs of the company so that the interest of all directors, clients, investors, employees, employers and I he general public are properly balanced.

Assessment of the Role of Parties to the Preparation and Publication of Financial Reports to Determine the Degree of Capability of Each Party

The essence of this assessment is to determine the parties that may have been responsible for the action or inaction that did not present financial reports according to the reality of the transactions entered into by the company and in doing so have the basis to suggest measures that should minimize if not prevent future occurrence.

The Management

It is the responsibility of management to manage efficiently and effectively the resources the owners had entrusted to them and render stewardship report. Any misstatements, misrepresentation, error and indeed fraud discovered in financial reports are the responsibility of management. This is so because management does not require anybody's directive on the day-to-day management of the organization. Abel, A1G. Asien (2002:29) agrees with this view: the management learn represents the "controlling mind" of the corporation and should also be directly culpable for its actions and inactions. In the African petroleum case for instance, it was management that concealed the indebtedness of the company from the financial reports. In the Enron Saga, it was reported that the Enron management and a partner in Andersen illegally shredded some documents to hide the dirty deal. It was reported too that the performance of the company was exaggerated because commission of some key officials of the management team was tied to the company's earnings.

The External Auditors

Auditors are expected to act as 'watch dog' and not a bloodhound. This view was expressed in the Kingston Cotton Mill Case 1896. What this means is that an auditor does *not prima facie,* make up his or her mind that he or she is going to discover fraud or irregularity in his / her clients financial statements but if in the course of his / her audit assignment any circumstance / incident puts the auditor on enquiry (arouses suspicion) he / she should probe such suspicions to the bottom.

In the African Petroleum saga, the management had concealed the indebtedness of the organization from the books, therefore, the auditors were not aware of their existence to have prompted circularization and verification of liability.

In the Enron case. Andersen allowed dealings involving limited partnership and special purpose entities to be treated as off-- balance sheet events (Abel 2002; P 30). The auditors ought to have known that if these documents were cumulatively analyzed they could materially affect the financial statements. Andersen admitted error of judgment, which it blamed on hiding of vital information. Auditors are liable under the law for negligence of duty. The liability of the auditor is determined by the circumstance of a case.

The Internal Auditor

Internal Auditors are to ensure that the internal control and-internal check designed for the organization are followed in the day-to-day management of the organization. The dilemma of the internal Auditor, however, is that he / she is part of the management team. He / she reports to the head of management. He / she can compromise easily for fear of possible victimization by the head of management to whom he / she reports.

Were it not for the lack of independence of the internal auditor, regular check and evaluation of internal control could have forestalled the incidents on AP and Enron. In the AP case, the Internal Audit Dept. could have queried the disappearance, from the financial statement, of the debt-contracted form some banks to pa\ dividends and even informed the external auditor who conducted the due diligence on the accounts of AP. After all. the role of the internal Audit is supposed to complement the role of the external auditor. The same query could have been raised in respect of certain documents hidden by the management in the Enron case.

The Audit Committee

The audit committee is expected to work in close collaboration with the internal auditor. Had they done that they could have known the problem with Management: The money borrowed by the management of AP but which was concealed could have been brought to their knowledge. In the Enron case Abel AG (2002 P. 29) highlighted the role played by the audit committee: The Audit committee of Enron which was supposed to check the auditors and the excesses of the management in the overall interest of the ultimate owners, the shareholders, failed to perform its duties particularly because of conflict of interest. When interests are conflicting, it could impact negatively on the expected performance of a person or body of persons.

Directors

If the directors carryout sufficient surveillance on the activities of management their excesses can be checked because the directors formulate the polices that management implements in the day-to-day management of the enterprises, but owing to compromises bordering on personal interests of Directors at times, they may fail to carry out the role expected of them.

Effects of Misrepresentation of Facts on Financial Statements

First and foremost, the confidence of users of financial reports would be eroded resulting into the following actions by them.

- Local and foreign investors would not be willing to invest in an economy because the security of their investment may not be guaranteed.
- Lenders of money and suppliers of trade credit would not be willing to extend such facilities to the needy.
- Government revenue from company profit tax would fall considerably as a result of low investment activity.
- Stock market activity could become less vibrant if not tend towards extinction as people would not have confidence in the share price movement on the stock exchange.

All the above effects would have negative consequences on the economy in the form of low investment, low output, low employment lo\v income, low demand with possible attendant social vices.

Suggestions Towards Improving Corporate Reporting

This section seeks to make suggestions that could make financial reports more credible and reliable.

(1) Integrated Approach to Reporting

All those responsible for financial reporting should discharge their respective responsibilities such that financial reports would reflect the actual performance of the enterprise and not perceived performance of the enterprise.

(2) **Ethical Re-Orientation**

Ethical and moral decadence is a common feature of our society today giving rise to absence of probity and accountability. People in management position should be persuaded to imbibe ethical and moral values that would manifest in their being accountable for management of people's resources.

(3) **Imposition** of Sanctions on **Erring Members of Professional Bodies**

The ICAN, ANAN, NIM, etc whose members, in most cases, constitute the management team of most organizations should fashion code of conduct for members and where one already exists, ensure that members keep strictly to them in the course of their actions in organizations. Where a member is defiant, appropriate penalties that are deterring should be imposed.

(4)Employment of Professionals

People who have requisite professional knowledge and skill recognized by the law should be employed so that if members violate code of professional ethics they can be brought to book.

(5) **Extension** of Scope **of Work of Professional Bodies by Regulatory Bodies**

Regulatory bodies should re-examine the existing legal framework for reporting financial activities with the view to improving on them so as to curb the high incidence of financial mismanagement and misinforming users of financial reports.

(6) **Involvement of Management in the Ownership of Enterprises**

Management should be involved in the ownership of enterprises. This may discourage them from perpetrating financial malpractices because the collapse of an enterprise could affect their interest adversely. This is also the opinion of Nogel and turnbull's (1999) guidance on internal control. According to them, management should have equitable or proprietary interests in the organization so that if they mismanage or falter in their professional duties their investments would also be affected (Abel 20()1, P. 3 1).

(7) **Relationship of Directors with Internal Auditors**

The directors should work in close collaboration with the internal auditors so that the former could get information about the goings-on in the enterprise. After all, internal auditors are to ensure that the internal control systems of an organization are implemented as designed. This collaboration can be made more effective if internal auditors commence reporting to the directors and not head of the management team then the directors can conduct proper surveillance over the activities of management.

(8) **The Law Should Guide Against the Possibility of Compromises of Interests by All Parties Involved in Corporate Governance**

For instance, in the Enron case, the audit committee compromised because of conflict of interests. Abel (2002: P. 29) asserts: it is on record that Enron made substantial donations to the political campaigns of Phi! Gramm. the husband of Wendy Gramm, chairman of the Audit committee! Lord Wakeman, a member of the committee also had a consulting contract with Enron.

Conclusion

In concluding this paper, attempt is made to answer the question; To what extent can users of financial reports rely and depend on them for the purpose of making economic decisions?"

The fact of the matter is that financial statements (reports) remain the medium for reporting the financial performance of enterprises and the basis for making decisions and it is likely to remain so in the foreseeable future.

Financial reports can be made more credible and reliable if all the parties involved in the production and publication of financial reports imbibe honesty and integrity as a role model and are conscience-driven in the approach to their work. This is so because no matter how stringent the legislation and the regulations may be people who are morally bankrupt would still perpetrate fraud not minding the consequences either on them or on the economy. However, this does not obviate the need for government and regulatory bodies to fashion regulations that are deterring and which the government has the will power to implement to the letter not minding primordial sentiments as is the case in contemporary Nigeria. Until the factors which give rise to erosion of users' confidence in financial reports are sufficiently and adequately addressed users of financial statements should use them with caution mindful of the possibility that there may be more to the contents of the financial reports than meets the eye.

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