An Investigation of the Impact of Material Misstatements on the Quality of Financial Reporting for a Public Sector

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Abstract

Over the years, financial reports have been associated with material misstatements, which may result in wrong decision making, ineffective strategies or even financial loss for both internal and external users who rely on such financial statements. Government departments are also notorious for this phenomenon. This study aims to investigate the impact of material misstatements on the quality of financial reporting at the government department in Gauteng Province, South Africa. Fourteen participants, consisting of accountants, auditors, assistant directors and directors, were selected to participate in the interviews. Data were collected through semi-structured and open-ended interview questions. The qualitative research method was adopted for the study to gain an in-depth understanding of the research problem and answer the research questions. The findings of the study revealed that financial information such as a lack of timely and detailed reports; human intervention, where people tasked with the preparation of financial reports make mistakes or lack adequate and relevant information; reporting; and accounting as well as noncompliance with standards, are all possible sources that have led to misstatements within the organisation.

Keywords: material misstatements, internal audit, financial report, financial statements

1. Introduction

The Gauteng provincial government has not received a clean audit several times, leading to some doubts about the quality of financial reporting. The gap between clean audits and unqualified reports obtained by the department over the past five years lies in the reduction in the number of material misstatements that were identified by the Auditor General during the audit. Clean audits assure the community that there is good governance within the public sector, and they restore confidence in the public and taxpayers. According to the provincial reports, fewer than four departments obtained clean audits during the previous financial years. The main drive is tight controls designed to detect material misstatements in the annual financial statement.

The research is aimed at identifying the weaknesses within the process of preparing financial statements and reducing the number of material misstatements to zero to achieve clean audits. Error or fraud in the financial statements can cause the shares of the company to fall. For example, fraud at Steinhoff caused their shares price to collapse due to accounting irregularities (Naude et al., 2018).

The research explores the causes of the increase in the number of material misstatements that have since been reported by the Office of the Auditor General. Lack of review and clear guidelines by management within the provincial departments over the past years has led to a deficiency in the accounting unit. As a result, the Office of the Auditor General has raised several findings related to weaknesses in internal control. Subsequently, service delivery to the community has since been hampered by a lack of clean governance due to failure to reduce the number of material misstatements raised in the departments. This study aims to examine the cause of the increase in the number of material misstatements to identify the weaknesses within the process.

2. Literature Review

2.1. Effects of material misstatement on quality of financial reporting

Financial reporting needs to comply with total quality management (TQM) as part of quality assurance. TQM is defined as a complete management attitude that endeavors and pushes for incessant improvement in every activity at every level of the organisation (Valmohammadia & Roshanzamir, 2015). Quality of financial reporting is achieved by applying the principle of TQM from acquiring the service delivery resources up to the point of after-sale service to the consumer. For an organisation to know the value of quality it is delivered to its clients, the estimates of the quality of service can be attained by deducting the score of the consumer expectation of the service from the consumer's perception scores of such service (Izogo & Ogba, 2015).

The international accounting standard board (IASB) stipulated certain elements that define the quality of a financial statement, namely, relevance, which is closely linked to concepts such as usefulness and materiality (Herath & Albarqi, 2017). When an economic decision made by an individual or an organisation is influenced by information stated in the financial statement, such information is said to have quality relevance. Information required for financial reporting must possess quality in terms of reliability before it can be used. Reliability entails that the information, as stated in the financial report that the user depends on is free of bias and material misstatement. The reliability of information can be tested by other qualities, such as the verifiability, faithfulness, and neutrality of the information. Financial reporting must pass the test of comparability. Comparability relates to the ability of users to compare financial statements across different times and between companies, especially in the same period. However, comparability requires that the events being recorded be identical. Understandability: this relates to how well the user is able to understand the financial report through effective communication, which means that the better the understanding of the user of the financial report, the higher the level of quality of the financial report. Timeliness: this relates to making the information available to decision makers when such information still has the power to influence the decision. Faithful representation relates to how the compiler of the financial report reflected and presented the actual economic position of the organisation. Auditors have a role to play in making this happen through an audit report that provides reasonable assurance of the level to which the financial report represents the true economic position of the organisation (Herath & Albarqi, 2017). Quality financial reporting benefits business development and economic decisions (Sripan & Wisaeng, 2022). The other factor influencing the quality of financial reporting is the tenure of the auditors and audit fees. The longer auditor tenure and higher incentives promote the auditor's independence, which by extension, improves the quality of financial reporting (Otuya, 2019).

2.2. Factors influencing the quality of financial reports

2.2.1.The practice of Corporate Governance

Corporate governance has an essential role in ensuring the quality of financial reporting. The relationship between corporate governance and the quality of financial reporting has been extensively studied. A study by Honu and Gajevszky (2014) revealed how the governance mechanism positively and significantly influences the financial information quality of companies. Mainly, influence from outside users, families, and stockholders negatively affects the quality of financial reporting; however, control by government and financial institutions is linked with a high-level quality in financial disclosures. Investigating the rule of governance mechanisms on financial information quality illustrates that corporate governance affects accounting quality (Klai & Omri, 2011). Companies with strong corporate governance can issue high-quality financial reports (Cao et al., 2011). The efficient corporate governance of financial reporting processing constitutes an important tool in allowing companies and their auditors to fulfil all these responsibilities (Hope et al., 2011).

2.2.2.Internal control

Effective internal control always lowers information risk and enhances the completeness and accuracy of planned information. According to the American Institute of Certified Public Accountants (AICPA), to produce reliable financial statements and achieve financial reporting objectives, strong internal control over financial reporting is one of the essential factors to achieve this purpose. It is also one of the important influences on financial reporting quality that impacts information risk and credit ratings (Elbannan, 2009). Therefore, the stronger and more effective the internal control is, the higher the quality of financial reporting achieved. The internal control system and financial accounting system positively influence the quality of financial reports (Bangsa, 2018).

2.2.3.Internal Reporting System

The internal reporting system checks whether the financial information meets the criteria of understandability, relevance, reliability, and comparability to ensure that economic decisions are made. It also enables interactions and communication between the management and operational levels. The importance of the reporting system comes from being a tool that provides representative and relevant information (Lius, 2011). Furthermore, the internal reporting system emphasises that more reliability should be achieved. An effective internal reporting system encourages producing high qualitative disclosures. For example, audit standards require an auditor's intermittent report, which provides reasonable assurance that no material misstatement exists in an organisation's financial statement and financial report as a whole (Backof, 2014). The greater the internal auditor independence of internal auditor accountability and transparency, the greater the effectiveness of internal audit reporting (Anojan, 2022). Agbenyo and Cobblah (2018) found that a unit increase in collection performance results in an improvement in the quality of financial reporting. The authors recommend that the internal control systems be well monitored and regulated.

2.2.4.Information Technologies and Accounting Information Systems

The accounting information system should produce relevant and reliable information (Sacer & Oluic, 2013). The usage of appropriate information technology (IT) is essential to the accounting information system because of all the support to the accounting information system to generate required information in a short period of time. Information technology has a considerable influence on the accounting information system from the perspectives of operating, preparing, processing, presenting, and delivering the accounting information. Thus, this significantly helps to support timeliness as a qualitative characteristic of financial information that results in increasing financial reporting quality and supporting the quality of accuracy by using effective IT (Sacer & Oluic, 2013).

2.2.5.Auditing

According to Ruppert (2016:1), auditing is a formal, systematic and disciplined approach designed to evaluate and improve process effectiveness and related control. Since auditing is an integral part of the system, the inclusion of auditing variables better reflects overall financial reporting quality (Tang et al., 2012). The aim of carrying out an audit of a financial statement is to convey an audit opinion as to whether a financial statement fairly presents the financial position of an organisation being audited at the end of a financial year and the results of its operations for that financial year (Auditor General South Africa, 2017:1). Auditors play a key role in contributing to the credibility of the financial statements on which they are reporting (Ismail et al., 2019).

2.2.6.Audit committees

First, the audit committee has the responsibility for hiring, evaluating performance, and compensating external auditors in entities. Additionally, audit committees oversee and supervise financial reports and disclosures of entities by monitoring choices of policies and accounting principles and what internal control designs management has used (Crous, 2017; SAICA, 2017). The more independent, capable, and qualified the audit committees are, the better their ability to detect material misstatements in the financial information and the better their ability to deter any opportunities for management to manipulate reporting. Thus, audit committee attributes have fundamental impacts on both financial reporting quality and audit inputs. The need for auditors to remain independent should not be allowed to provide audit clients with any other advisory services and at the same time should be periodically rotated to improve their independence (Iwarere & Pavtar, 2016). Prior researchers have provided some evidence that suggests an association between the existence of a financial expert on an audit committee and a higher level of financial reporting quality (Krishnan & Visvanathan, 2008). However, the importance of including a financial accounting expert on the audit committee has resulted in higher financial reporting quality than just including a financial expert (Zang, Kim, Benjamin& Dan, 2013). Having a financial accounting expert on audit committees is positively associated with forecast accuracy and negatively associated with forecast dispersion (Abernathy, 2010). The external auditor’s competence trust and integrity trust in the audit committee members are two strong motivators, which improve their interactions with the audit committee (Cheung & Lai, 2022).

3. Research Methodology

The study employed a qualitative research approach. The target population includes employees of the finance and accounting department at the Gauteng Provincial Department. The target population consisted of an estimated 25 employees of the finance and accounting department. A sample size of 15 participants was purposively drawn from the employee database of the GDID with contact details. Data were collected through semistructured interviews. An interview guide consisting of a series of interview questions relating to financial misstatement was used to collect data from participants.

In addressing the research aim relating to the impact of Material Misstatements on the Quality of Financial Reporting for a Public Sector, a thematic analysis was adopted. The recorded data were transcribed verbatim, and the transcriptions were analysed through thematic analysis. Thematic analysis focuses on searching for themes or patterns that occur across the data (Saunders et al., 2016). In this research, the thematic analysis began with the coding of the data to identify patterns for further analysis (Saunders et al., 2016) which was then categorised and developed into themes. The themes were aligned with the research questions.

Since the research was conducted in an interprevist paradigm, the normal criterion of validity and reliability is replaced with four criteria of trustworthiness and authenticity, which include credibility, dependability, confirmability and transferability (Kivunja & Kiyuni, 2017).

Credibility refers to the extent to which data and data analysis are believable, trustworthy or authentic. For this study, the researcher made sure that the question and responses from participants were clarified during the interview, before moving on to the next question. At the end of each interview question, the research recapped and summarised the views of the participants and asked them to confirm the researcher's understanding of their views.

Dependability is the ability of observing the same outcome or finding under similar circumstances (Kivunja & Kiyuni, 2017). For this study, the participants were encouraged to express themselves freely during the interview sessions while the researcher remained an active listener.

Confirmability is the extent to which the findings of the research can be confirmed by others in the field (Kivunja & Kiyuni, 2017). The overriding goal of this criterion is to ensure that researcher's biases are minimised and preferably eliminated to guard against contaminating the results of the data analysed (Kivunja & Kiyuni, 2017). The researcher did not express a position or preference to the responses. The researcher also ensured that there were no biases in the way questions were framed and also not pushing participants to respond in the researcher's favour.

Transferability represents the researcher's efforts to ensure that enough contextual data about the research is given so that readers of the findings can relate those findings to their own contexts (Kivunja & Kiyuni, 2017). For this research, a convenient time and venue setting was provided to the participants. The context of this study was fully described, and its findings can be related to other contexts.

4. Research Findings

The intended total number of participants for the study was 15. Out of this total,14 participants accepted an invitation, making a response rate of 93.30%.

4.1. Demographic Profile

Table 1 below provides an overview of the demographic profile of the participants by gender, age, highest educational level, work experience and their roles in the company. Most of the participants were males (71.4%), with the remainder of the participants being females (28.6%). Regarding the age distribution of the participants, most of the participants were less than 50 years (85.70%), and the remainder fell under the more than 50 years age group (14.30%). Concerning the highest educational level of the participants, the majority of the participants had master's degrees (42.90%) as the highest educational qualification, followed by the participants who had bachelor's degrees (35.70%) as the highest educational qualification. Regarding the work experience of the participants, the majority of the participants had more than 10 years of work experience (78.60%), followed by participants who had 6-10 years of work experience (14.30%), and only 7.10% of the participants had less than 5 years of work experience. In terms of the roles and responsibilities, 64.30% of the participants were directors and assistant directors, 21.40% of the participants were accountants and 14.3% of the participants were auditors.

Table 1: Demographic profile of respondents

Characteristics of the respondents	***Frequency (%)***
Gender	
Female	4 (28.6%)
Male	10 (71.4%)
Age Group (years)	
18-25	
26-35	2 (14.30%)
36-49	3 (21.40%)
>50 years	7 (50%)
	2 (14.30%)
Highest Educational Level	
Diploma	2 (14.30%)
Bachelor	5 (35.70%)
Masters	6 (42.90%)
DPhil/PhD	1 (7.1%)
Roles	
Directors	5 (35.70%)
Assistant Directors	4 (28.60%)
Auditors	2 (14.30%)
Accountants	3 (21.40%)
Work Experience	
0 – 5 years	1 (7.10%)
6 -10 years	2 (14.30%)
11 -16 years	9 (64.30%)
>17 years	2 (14.30%)

4.2. Thematic Analysis and Discussion

Table 2: Thematic Analysis

Research Objectives	*Themes*
To determine the nature of financial misstatement	Prior period errors Incorrect calculations Unidentified Irregular Expenditure
To determine the possible sources of the misstatement	The role of financial information The role of human intervention

	Noncompliance to standards
To determine the impact of the misstatement of the quality of financial statement	Relevance of annual reports Decision making Lack of achievement in clean audits
To make recommendations to the management of GDID on ways to reduce financial misstatement and improve the quality of GDID's financial statements	Adhering to recommendations Establishment of risk management and audit committee Effective internal control unit

4.2.1.The nature of financial misstatements

The first objective sought to determine the nature of financial misstatements within the organisation. Prior period errors have been identified among the nature of financial misstatements within the department. According to the 1st Participant, "*the department during every financial year is restating the previous financial balances based on information that was not shared with relevant individuals at the appropriate time*". Ideally, this information would only surface long after the financial statements are submitted for audit or after the audit has been completed. The 3rd Participant emphasised that most of these material misstatements are repeat findings raised by the auditor general. The 13th Participant further emphasised that misstatements arise due to errors that could have been prevented had thorough independent reviews been performed by senior officials. Therefore, prior period errors rest among the nature of financial misstatements within the department.

The study also found that incorrect calculations result in financial misstatements within the department. According to the 5th Participant, there are various ways that lead to incorrect calculations and misstatements. One example mentioned by the participant is the incorrect calculation of income. Ideally, an error in properly recording sales results in a misleading net income figure, and a miscalculation of sales or net income leads to an incorrect valuation. Incorrect calculation of expenses also results in misstatements. As predicted by the 7th Participant, "*expenses form a major portion of the income statement, and miscalculating expense items affects net income*". Therefore, without having an accurate reading of organisational expenses, the company might overspend or not allocate enough resources to sustain operations.

Unidentified irregular spending can lead to misstatements. The 1st Participant indicated that expenditure at times goes unnoticed, and this lead to misstatements. Participant 2 pointed out that "*irregular expenditure within the Public Sector arises from factors such procurement policy violations and insufficient details on immovable assets*". The report by the Auditor-General in 2018 highlighted that unidentified irregular expenditures led to a loss of R1.2 billion within the public sector alone (Daily Mirror, 2018).

4.2.2.The possible sources of the misstatement

The second objective seeks to determine the possible sources of misstatement. The participants argued that financial information plays an integral role in leading to misstatements. The 1st Participant indicated that "*financial information is the cornerstone of every financial reporting at any defined period*". In the department, the main contributing factor is the lack of financial information at every financial reporting period. Participant 2 affirmed that "*those who are tasked with the preparation of financial reports only use the information available to them at that time but only realise afterwards that the information that they utilised was either incomplete or unreliable*". The 7th Participant outlined those financial systems such as SAP, which are considered one of the best financial systems in the market and are not fully integrated into the financial reporting process of the department; as such, the system's capabilities are not fully utilised. This becomes the source of material misstatements in the annual financial statements, as most disclosure notes are prepared manually in the Excel spreadsheets, resulting in many errors due to the large volume of data being captured on spreadsheets. As discovered within the study, the department does not take advantage of the available technologies for financial reporting, and systems such as SAP are mainly used by the department for the payment of suppliers, not for reporting purposes.

In addition, financial information systems play a pivotal role in the sense that data captured should be accurate and complete. Failures of such issues will result in financial statements reporting errors. As stipulated by the 3rd Participant, "*financial information statement enhances the process of preparing quality financial statements which in turn will result in financials that are free from material misstatements*". This is mainly due to information being retrieved quickly and the relevant Portfolio of evidence being obtained in preparing the financials. Therefore, failure to correctly capture the financial information correctly results in material misstatements.

The human intervention also plays a critical role as a source of misstatements. As stipulated by the 9th Participant, "*human intervention is the major factor in the department because the organisation relies on everyone in the chain to play their role to have proper records".* The lack of exchanging information seems to be the biggest problem within the department. Furthermore, the 12th Participant argued that in most cases, material misstatements arise due to the lack of integrated systems. These systems should have minor human interventions to prevent the risk of misstatement. In addition, the 4th Participant offers another view of understanding human intervention as a cause of material misstatement. The participant argued that most material misstatements are because of a lack of oversight from top management. Some of these misstatements raised are because management overrides and do not adhere to the relevant controls that are implemented by institutions. In conformity, the 9th Participant argued that human intervention could be understood in a lack of proper independent reviews by senior officials, inconsistent implementation of internal controls such as performance of monthly reconciliation statements of creditors, payroll reconciliation and management of accruals and lack of communication amongst various Directorates

Noncompliance to set standards is also among the causes of material misstatements within the department. Accordingly, the 6th Participant argued that noncompliance with standards has contributed in some cases, but at most times, the problems emanate from the information that was used at that given time. The 11th Participant highlighted that a fraction of the material misstatements is as a result of noncompliance with accounting standards, with the bulk of the material misstatements being attributable to internal control deviancies, such as lack of discipline and due diligence by employees responsible for preparing disclosure notes as well as inadequate review mechanism by management.

4.2.3.The impact of the misstatement of the quality of financial statements

The third objective sought to investigate the impact of material misstatements on the quality of financial reporting. Misstatements impact the quality of the financial statement because they render the report irrelevant. According to Participant 2, "*material misstatements affect the reliability, usefulness and relevancy of the annual financial statements which are the underlying principles on the preparation of financial statements".* Ideally, poor-quality financial statements compromise the quality of the department's financial reports and lead to organisational inefficiency. Furthermore, the 1st Participant interestingly acknowledged that misstatements also affect the team tasked with the preparation of annual reports. This is because any misstatement reported will cast doubt on the team that prepared the financial statements and therefore undermine the intelligence of the entire team.

Within any organisation, decision-making is of vital importance because it leads to the direction of an organisation in achieving the desired goals and objectives (Blackwell, 2012). As stipulated by the13th Participant, "*financial statements are a true source of how the organisation performed and material misstatements impact greatly as they show that the financials were not compiled in accordance to the standards, this also affect the financial decisions of the one who relies on the statements*". For any organisation to map a way forward into the next financial year and beyond, there is a need to comprehend the financial statement, and if misstatements have been reported, there poses a challenge in decision making. Misstatements are also misleading in the interpretation of the organisation's financial statements. As stipulated by most participants, this may lead to unforeseeable litigation risks with negative financial implications within the organisation.

Generally, misstatements lead to a lack of achievement in clean audits. Participant 2 highlighted that within the department, the financial controls have not been effective as stipulated by the Auditor-General. For the past three years, misstatements have been recurring, which is an indication of an internal control deficiency, such that there is an urgent need to address the breakdown in internal controls. Thus, lack of clean audits is worrisome because it shows that the department has either been spending irregularly or there is a lack of accountability and transparency in the processes of the organisation.

The participants generally agreed that financial statements are a true source of how the organisation performed under financial management. Misstatements, as argued by the 12th Participant, have an impact on service delivery to the community, which stands as the focal point of the public sector. Furthermore, financial statements enable the organisation to identify where the department is utilising resources. However, errors within such reports, as argued by the 14th Participant, impact how an organisation is supposed to evaluate itself. Moreover, oversight departments such as legislation and provincial treasury rely on the financials prepared by the department to make accurate decisions such as forecasting and vote allocations. However, this can no longer be effective if there is a continued financial misstatement within the department.

4.2.4.Recommendations to the management of GDID on ways to reduce financial misstatement and improve the quality of GDID's financial statements.

The last objective sought to provide recommendations to the management at GDID on ways to reduce misstatement and improve the quality of financial statements. The respondents had various claims on how the GDID can improve the quality of financial statements. According to the 3rd Participant, "*there is need to ensure that the recommendations issued by the office of the auditor general are put into effect*". These recommendations include strengthening the monitoring of compliance with laws and regulations. Furthermore, the office of the AG recommended that there is a need to strengthen the supply chain management (SCM) control environment by conducting regular training to improve skills. According to the 5th Participant, this will reduce possible noncompliance that results in irregular expenditure.

There is also a need to establish certain institutions that guarantee that statements are reliable and valid. First, as proposed by the 12th Participant, there is a need to establish a risk management unit that ensures that financial reports are given attention. Furthermore, the 12th Participant argued that there is also a need to establish an audit committee that helps prepare financial reports to ensure that the financial statements prepared by government institutions are free from material misstatements.

Accordingly, the 5th Participant argued that the department needs an effective internal control unit that monitors controls of and organisation on a quarterly basis. The financial statements need to be reviewed by the internal finance team before being reviewed by the director of financial accounting. This is essential to ensure that the risk of errors is minimised. The 4th Participant argued that management should strengthen the internal controls relating to the preparation and review of financial statements and annual performance reports to ensure that the reports are free from misstatements relating to commitments, lease obligations, accruals, and payables not recognised and immovable assets.

5. Conclusions

The practices of corporate governance, internal control, accounting standards, internal reporting systems, auditing, auditing committees, culture, ethics and fraud are among the factors that may influence the quality of financial reports. The strategies for ensuring quality financial reporting include financial managers treating any item worth disclosing to the users as material, professional judgement being applied continuously in the effective application of the materiality on the financial statement, materiality being considered throughout the financial year through the application of adequate financial reporting processes, to mention just but a few.

Aspects such as prior period errors where the department during every financial year is restating the previous financial balances based on information that was not shared with relevant individuals at the appropriate time; incorrect calculations, where some fundamental aspects are skipped in detailing financial statements; window dressing; unidentified irregular expenditure and understatement of operating leases all determine the nature of misstatements. This study noted various possible sources of misstatement. Financial information such as a lack of timely and detailed reports, human intervention in which the people tasked with the preparation of financial reports make mistakes or lack adequate and relevant information, reporting and accounting as well as noncompliance with standards are all possible sources that have led to misstatements within the organisation.

Ideally, material misstatements impact the quality of financial reporting within the GDID. First, the relevance of the annual reports is undermined. This is because the information provided will be null and void. Furthermore, misstatements impact organisational decision making, in which these reports are supposed to be a fundamental source in structuring a careful decision that structures the organisation. The study also concludes that misstatements impact the quality of financial reports in the GDID because they result in a lack of achievement in clean audits and have an impact on service delivery to the community and evaluation of the organisation.

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