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# Surveying the Relationship between Legal and Financial Misstatement and Revision of Loss and Profit Figures in Governmental Companies

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**ABSTRACT:** High volume of accounting scandals in recent years has led to a loss of public trust in corporations and organizations have been audited. All these scandals have been associated with restatement of financial statements. In another words, all bankrupted companies in recent years have done financial restatement. In most cases, restatement of financial statements indicate a problem with the internal control system and corporate governance in companies which their reputation and values have been damaged in market and even in some cases it has been led to bankrupt them. So, the research tries to survey the relationship between legal and financial misstatements with restatement of loss and profit figures on listed companies in Tehran Stock Exchange within 2007 to 2012. The results of the research indicate that whatever tax, legal and financial misstatement of companies is high; their restatement of financial statements will be more.

**Keywords:** Legal Misstatement, Financial Misstatement, Tax Misstatement, Restatement of Financial Statement.

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## INTRODUCTION

Different aspects of simplifying tax system consist of simplifying laws and regulations, finding the simplest approaches, minimizing cost of tax compliance, avoiding changing frequently tax laws, using identical definitions and concepts, considering administrative costs, avoiding using limited applications of tax laws along with reducing the multiplicity of prices, simplifying prices, limiting tax incentives and so on. As in recent years, there is particularly attention to self-tax and voluntary participation of tax – payers, no doubt along with culture – building and update inform, the effectiveness and efficiency of this approach depends largely on tax – payers' ability and tendency in understanding and performing legal commitments and tasks and also the ability of tax and finance department for interpreting and conducting fairly tax laws. Many of those who are directly or indirectly involved in the tax system claim that the tax system is complex and believe that simplifying tax for ensuring self – tax programs on the one hand and increasing the efficiency of tax system on the other hand, is vital and important. No doubt, simplify the tax system is not possible without understanding the complexity of factors. To survey creating factors of complexity refers to two main groups from public factors resulting from executing tax policies and private factors resulting from dominant atmosphere on economic relations as creating factors of complexity of tax system (AICPA, 1993, 2002). In spite of performing various measurements toward modifying tax system in Iran in current two decades, simplifying tax system has been received less attention. From 1989 to 2005, over 900 directives have been issued to clarify tax laws which have been changed a little from 1967 (Karami, 2005). No doubt, the measurements for simplifying tax laws have been suffered various challenges. Although the main goal of tax system is to supply income for government, tax systems are sued to meet a set of social, economic and political goals. Law – makers and regulators should be aware that tax simplification should be in priority of objectives of tax policies and real simplification leads to political, social and economic advantages. Regulators should know that the complexity of tax laws is main reason of many complains about vague in forms, high cost of compliance and so on.

### 1. Theoretical Framework and Research Background

### 1.1 Theoretical Framework

### 1.1.1 Independent Variables

Auditing reports and Forensic inspectors' reports were used to define operationally independent variables of the research. Definition and manner of measurement of any variables as follows:

- **Financial Misstatements**

Usually, Claims about the ability of the audit profession are discussed to meet the needs of its users, but at the end of the last century and especially in the 1980s, these debates intensified. Before 1977, the accepted accounting principles of the United States emphasizes on this point that common tests are performed to present assessment about Financial Statements cannot be utilized and sufficed for embezzlement discovery or deliberate misstatement by management. The auditor only when was responsible for detecting fraud that failure to detect the fraud led to the unconformity with accepted accounting principles. But in 1977, the standards were revised and based on the revised AICPA auditing standards the auditors were emprise the responsibility of investigation and research about mistakes. In this research the purpose of financial misstatements, is deviation of companies from accounting and financial standards. To measure amount of performed financial Misstatements in the company, the independent auditor's report is used. If in the auditor's report the deviation from accounting standards is hinted and as for its importance, Conditional and unacceptable remark is issued, for this variable value of one and otherwise, a value of zero is considered.

- **Legal Misstatements**

One of the tasks of the independent auditor and specially legal inspector of the company is to check the status of legalities and Regulations (Including business law, cheque law and so on) of state that provide deviation of them auditor or legal inspector require to present report of non-compliance with legalities and regulations to board of directors and General Assembly. For operational definition of this variable, a dummy variable is used as if there are legalities (laws misstatement) in the report of auditor or legal inspector, value of one and otherwise, a value of zero is considered.

- **Tax Misstatements**

In this research, the intent of tax misstatements is Non-compliance with laws and tax regulations that mainly are related to tax evasions, concealment of income and so on. The main source of data collection is related to tax misstatements of audit reports of companies. If audit reports contain provisions about tax misstatements of companies, this variable amount is 1, otherwise 0.

**1.1.2 Dependent Variable**

- **Financial Restatement**

High volume of accounting scandals in recent years has led to a loss of public trust in corporations and organizations have been audited. All these scandals have been associated with restatement of financial statements. In another words, all bankrupted companies in recent years have done financial restatement. In most cases**,** restatement of financial statements indicate a problem with the internal control system and corporate governance in companies which their reputation and values have been damaged in market and even in some cases it has been led to bankrupt them.

One of the qualitative properties of financial statements is their comparability. To meet the property, consistency in the accounting practices in each fiscal period to the next period is necessary.

On the other hand, it has been emphasized in another part of the accounting standards: Financial statements should be included comparative prior period items; except in cases that an accounting standard may be permitted or required, then according to the requirement to represent comparative figures and maintain the consistency of the way from a period to another period, It is always expected that the presented figure for each financial elements in the current period financial reports, be equal with restatement figure for the same case in the financial reports of the next year, however, in some cases, based on reasons that are referred to them later, This equality does not exist. Not being equal of primary presented figure of financial statement items with restatement figure, is Often caused by one or more cases of factors of change in accounting policy, errors, done estimates revision by management, and change the classification of items. Among the four mentioned factors, Only the first two factors; that is, change the classification of items and correction of errors are belonging to the classified annual adjustments and their effect are retroactive. In fact, the purpose of numbers of restatement in this research is changes that may have been occurred as a result of one of the two mentioned factors, and done changes has not been considered due to classification changes and changes in estimates in counting the number of occurred restatements. In the accounting literatures have been explained various reasons for restatement of financial statements that most of them had significant relationship with amount of restatements.

Apart from the direction of their changes, to measure the absolute value of the change, it is enough to figures of any accounts in years are compared with the same figures with previous year which restatement has not been occurred. Then we calculate an average for these changes which are 6 cases. These changes could be occurred in any permanent and temporary headings (retained Earnings) based on research background and initial studies of companies' financial statements.

**Research Background**

Lanis and Richardson (2011) examine effects of composition of board of directors on bold and reductive tax policy. Legit regression results for selective sample of 32 companies which including 16 firms that have tax bold behaviors and 16 firms without tax bold behaviors show that existence of high share of external members of board of directors, reduce the possibility of bold and reductive behaviors. The least squares of regression that indicates the sensitivity of the cross-sectional analysis of 401 firms confirm the main results about the composition of the board of directors and tax bold behaviors.

Alastair et al. (2011) in Canada investigated this issue that "does the differences in audit quality indicators in the big audit firms against not big audit firms is related to the characteristic of test unit". They found, the effects of the big audit firms on unusual accruals of testing units in comparison with the effects of not big audit firms on unusual accruals of testing unit, has no significant difference.

Wilson (2008) tested reduced information content of profit after restating. The results indicated that profit has relatively lesser information content after restating. The companies restate information statements due to miscalculating income identification and the companies have experienced highly the reduction of share price in date of restatement, the companies have changed their auditors and member of board of directors, all of them have been suffered less information content.

**MATERIAL AND METHODS**

The methods of descriptive statistics including mean, variance, standard deviation and quartiles will be used to explain the variables. In addition, T and F-statistics are used to test the hypotheses. Of course, regression pre – tests such as normality and lack of self – correlation will be used. For considering the data, at first we survey descriptively the data and then test the hypotheses. Excel software was used to analyze the collected data and mixed data method was used to test the hypotheses. This research was done from 2007 to 2013.

**Research Hypotheses**

**1.** In the companies which tax misstatement is high, financial restatement is more.

**2.** In the companies which financial misstatement is high, financial restatement is more.

**3.** In the companies which legal misstatement is high, financial restatement is more.

**RESULTS**

**Hypothesis 1:** In the companies which financial misstatement is high, financial restatement is more.

Surveying the results of t-test about first hypothesis indicates that there is a significant difference between financial restatements with and without financial misstatement s at 5% error level (sig = 0.023). Then $H_1$ is supported and $H_0$ is rejected with 95% confidence. We accept this claim that the average of companies has higher financial misstatement s (8.468), the difference of their financial restatements is higher than the companies have lesser financial misstatement s (7.719). Because upper and lower limits of two statistical populations are negative, then average difference of two societies will be lesser than zero. It means that the average of financial restatement in the companies have high financial misstatement s is higher than the companies lesser financial misstatement s. This claim can be seen in the results of average of companies.

**Hypothesis 2: in the companies which tax misstatements are high, revision of financial statements will be more.**

$H_0$: $\mu_1 = \mu_2$

$H_1$: $\mu_1 \neq \mu_2$

According to above table, significance level of t – statistics is lesser than 5 % (sig = 0.000). Then $H_0$ is rejected and $H_1$ is supported with 95% confidence. We accept this claim that the average of companies has higher tax misstatement s (9.178), the difference of their financial restatements is higher than the companies have lesser tax misstatement s (7.831). Because upper and lower limits of two statistical populations are negative, then average difference of two societies will be lesser than zero. It means that the average of financial restatement in the companies have high tax misstatement s is higher than the companies have lesser tax misstatements. This claim can be seen in the results of average of companies.

**Hypothesis 3: in the companies which legal misstatements are high, revision of financial statements will be more.** $H_0$: $\mu_1 = \mu_2$ $H_1$: $\mu_1 \neq \mu_2$

**Table 1.** Result of independent t-test of financial restatement

| | | | | | | Confidence distance | | |
|---|---|---|---|---|---|---|---|---|
| Variable | Financial misstatement s | N | m | t | Sig. | Upper limit | Lower limit | result |
| Financial misstatement | No | 41 | 7.719 | -2.154 | 0.023 | -0.061 | -1.437 | There is difference |
| | Yes | 79 | 8.468 | | | | | Rejected $H_0$ |

**Table 2.** Results of independent t-test in financial restatement

| | | | | Confidence distance | | | | |
|---|---|---|---|---|---|---|---|---|
| Variable | Financial misstatement s | Nr | M | t | Sig. | Upper limit | Lower limit | result |
| tax misstatement | No | 86 | 7.831 | -4.557 | 0.000 | -1.761 | -1.935 | There is different |
| | Yes | 34 | 9.178 | | | | | $H_0$ is rejected |

**Table 3.** The results of independent t-test in financial restatement

| | | | | Confidence distance | | | | |
|---|---|---|---|---|---|---|---|---|
| Variable | Financial misstatement s | N | Mea | t | Sig. | Upper limit | Lower limit | result |
| tax misstatement | No | 20 | 7.117 | -3.025 | 0.003 | -0.454 | -2.174 | There is different |
| | Yes | 120 | 8.431 | | | | | $H_0$ is rejected |

As can be seen in table 4-8, significance level of t-statistics is smaller than 5% at 5% error level (sig = 0.003). Hence, $H_0$ is rejected and $H_1$ is supported. We accept this claim that the average of the companies has legal misstatement s (8.431) is their financial restatements higher than the companies have less tax misstatement s (7.117). Because upper and lower limits of two statistical populations are negative, then average difference of two societies will be lesser than zero. It means that the average of financial restatement in the companies have high legal misstatement s is higher than the companies have lesser legal misstatement s. This claim can be seen in the results of average of companies.

## DISCUSSION

Misstatement in financial statements can be resulted from cheat or error. Fraud consists of any action intentionally and deceptively by one or more managers, employees or third parties for enjoying an illegal and undue advantage which it is important naturally. Regardless of occurred loss in present or in future, the basic point is that the existence of fraud can have serious risks, except that punitive measures should be predicted or at least, preventive measures to be taken. It should be noted that based on audit guidelines about auditing risk management, auditor is required to report financial effects resulting from minor errors or misstatement s as a section in reports (after commenting). On the other hand, auditors are appointed as legal inspector of company in Iran. So by virtue of the amendment of Article 151 of the Commercial Code, auditor or auditors must notify to general assembly any infringement or wrongdoing in company's affairs by managers and CEO. If he becomes aware of crime occurrence during his mission, he should inform competent judicial authorities and the first general assembly (Gheydari, 2004). According to above explanation, the research tries to survey financial restatement in terms of legal, tax and financial misstatement s. The summery of the results as follows:

**Hypothesis 1: in the companies which there are high financial misstatements, revision of financial statement is more.**

According to t-test, it should be noted that there is a significant difference between revision in financial statements in companies with and without financial misstatement s at 5% error level (sig = 0.023). We accept this claim that the averages of the companies which have high financial misstatement s (8.468), their revision of financial statements are higher than the companies have less financial misstatement s (7.719). In other words, the average of financial statement revision in the companies which have high financial misstatement s is higher than the companies have less financial misstatements. Financial misstatement s refer to companies' deviation from financial and accounting standards. In other words, the companies have deviation from accepted principles and financial and accounting standards, financial misstatement has been occurred. This misstatement can be intentionally or inadvertently. On the other hand, according to the requirement for providing comparative figures and maintaining consistency from a period to another period, it can be expected that provided figures for any financial items in financial reports of current year are identical with revised figures for the same financial reports in next year. But in some cases there is this equality. Lack of equality in initial figures of financial statements with revised figures are resulted from one or more cases including change in accounting approach, errors, revision in made estimates by management and change in item classification. Among above factors, only change in accounting approach and error modification is included annual classified adjustments and their effect is retroactive effect. In fact, made changes because of change in classification and estimations have not been considered in counting the number of occurred revisions.

According to above explanations, legal misstatement does not include two cases from revision of financial statement which encompass changing approach in accounting and error modification. Rather, it is a deliberate mistake. After identifying behalf inspectors, auditors and related entities, needed measures should be conducted in regard of revising financial statement and adjusting entries are made on the books. According to the results, the companies have high financial misstatements; their revision of financial statement is more.

**Hypothesis 2: in the companies which there are higher tax misstatement s, revision of financial statements is more.**

According to t – test, it should be noted that significance level of t – statistics is smaller than 5% (sig = 0.000). It implies we accept that the averages of the companies which have higher tax misstatements (9.178); their revised financial statements are more than the companies have lesser tax misstatement s (7.831). In another words, the average of revised financial statements in the companies which have high tax misstatement s is higher than the average of revised financial statements in the companies which have lesser tax misstatement s. In analysis of this hypothesis, it should be noted that tax misstatement refers to non-compliance with tax laws and regulations, mainly related to tax evasion, income concealment and so on. There are many influential factors such as economic conditions, inflation, social and mental factors and culture of tax evasion. In fact, many companies do tax misstatement by paying less tax and its reason can be lack of transparency in tax laws and regulations. The major source for collecting information related to tax misstatement s is auditing reports of companies that this leads to increase the revision of financial statements of companies. According to this result, it should be noted that the companies have higher tax misstatement; means they circumvent regulations; their revised financial statements are more. Its reason can be manager' intent to failure to pay taxes. The result of this hypothesis is not compatible with Shams Zadeh and Zokori's research (2008). They found that discrepancies between accounting standards and tax laws will not occur significantly in state of accepting official documents. Also, the result of this hypothesis is not compatible with Safari's research (2006). He found that difference reasons and gap between instrumental profit and Profit Diagnostic consist of possible ambiguities in the provisions of the Acts and the implementing guidelines, manner of dealing with them, lack of knowledge about tax laws behalf tax – payers and lack of capability for executing tax laws because of undesirable condition ( in terms of time and place). Because this hypothesis notices that tax misstatement leads to make this gap.

**Hypothesis 3: in the companies which there is higher legal misstatement s, revision of financial statements is more.**

According to t- test, it should be noted that t – statistics amount is smaller than 5% at 5% error level (sig = 0.003). We accept this claim that the average of the companies which have legal misstatement s (8.431) is higher than the companies have lesser tax misstatement s (7.117). In another words, the average of revised financial statements in the companies have high legal misstatement is higher than the companies have lesser legal misstatement s.

In analyzing this hypothesis, it should be noted that one of independent auditor's tasks, especially legal inspector of company, is to control the status of laws and regulations compliance (including business law, cheque law). If any deviation is occurred, legal inspector or auditor is required to report this infringement to board of directors and general assembly. Legal misstatement refers to circumvent financial regulations which make the revision of financial statement. In this hypothesis, it should be noted that many companies conduct legal misstatement for different reasons to gain more profits. It should be attended that many factors can achieve organizational goals in this regard. But the existence of legal uncertainties is one of the most important factors for performing these misstatements.

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