

Impact of Financial Statement Fraud, Accounting Profit, Cash Flow, and Financial Decision on Stock Returns

Muhammad Imran Farooq¹, Hassan Abbas², Shahroz Masood³, Javaria Manzoor⁴

¹ Department of Economics and Social Development, University Malaysia Terengganu, Malaysia

²Department of Commerce, Bahauddin Zakariya University, Multan, Pakistan

³Department of Business Administration, University Putra Malaysia, Malaysia

⁴Department of Business Administration, Air University Multan, Pakistan

Abstract: The study analyzes the impact of financial factors on stock returns in Pakistan's Cement industry from 2010 to 2020, using secondary data from annual reports and official company websites. The findings reveal that while cash flow has a negative but insignificant effect on stock returns, financial decisions and accounting profits both show a positive and significant influence, indicating that sound financial management and profitability attract investors and enhance returns. Conversely, financial statement fraud has a significant negative impact, highlighting the importance of transparency and ethical practices. The study concludes that investors should focus on companies with strong profits and operating cash flows while being cautious of risky financing practices that may misrepresent a firm's financial health.

Keywords: Cash Flow, Stock Returns, Financial Decision

Email: P4100@umt.edu.my

1. Introduction

Investors participate in the stock market intending to generate financial returns, which primarily come in the form of stock returns. These returns represent the profits earned from holding shares and can materialize through two main avenues: dividends *and* capital gains [2]. Dividends are periodic payments distributed by companies to shareholders, typically funded from corporate profits [3]. The frequency of these payments - whether quarterly, semi-annual, annual, or occasional special dividends, depends on the company's profitability, cash flow stability, and dividend policy.

On the other hand, capital gains arise when investors sell shares at a price higher than their purchase cost, reflecting appreciation in stock value over time [4]. However, stock returns are inherently volatile, influenced by company-specific factors (e.g., earnings reports, management decisions, product launches) and broader economic forces (e.g., interest rates, inflation, fiscal

policies). Domestically, risks such as political instability, regulatory shifts, labour strikes, or sector-specific downturns can destabilize markets [5]. For example, a sudden tax hike on corporate profits in Pakistan could reduce investor confidence, leading to stock sell-offs. Globally, events like pandemics, geopolitical conflicts, supply chain disruptions, or fluctuations in commodity prices (e.g., oil, wheat) create cross-border ripple effects. The 2022 Russia-Ukraine war, for instance, disrupted global energy and grain markets, indirectly impacting Pakistan's inflation and stock valuations [6].

Even dividends, often seen as stable returns, are not guaranteed. Companies may slash or omit payouts during financial distress, as seen during the COVID-19 pandemic when many firms prioritized liquidity over shareholder payouts [7]. To manage these uncertainties, investors employ strategies like *diversification* (spreading investments across sectors/regions) and *hedging* (using derivatives to offset losses). Despite such measures, stock markets remain unpredictable, blending opportunities for wealth creation with exposure to ever-evolving risks, making informed analysis and adaptability critical for long-term success [8].

Numerous disputed research studies have examined the efficacy of income statement indicators based on accruals in evaluating companies' current and future performance [9]. The dispute between academic research and the financial world has been more heated with the increase in company failures, especially those whose income statements indicated high net income but low cash liquidity. The cash flow statement, financial position statement, and income statement are all interconnected and supportive of one another rather than competing with one another [10]. Al-Rjoub [11] looked at the connection between market stock returns and profits per share. They discovered that industrial businesses listed on the Amman Stock Exchange's market stock returns could not be explained by changes in earnings per share or their levels by more than 9.9%. Several methods of calculating profits improve comprehension of market stock returns and minimise bias mistakes.

According to Miller and Modigliani [12], a company's earnings dictate the number of dividends it will pay out, and the size of this payout also impacts the price. Increased profits result in higher dividend payments and a higher stock price for the firm. The better the firm performs, the higher the net profit it achieves.

This study examines the influence of financial decisions, accounting profits, cash flows, and financial statement fraud on stock returns, highlighting a gap in existing research specific to

Pakistan. Previous literature offers mixed findings regarding financial decision-making; for instance, Kasmiasi and Santosa [13] and Jusriani and Rahardjo [14] found a significant positive relationship between financing decisions and firm value, while Arifah and Roifah [15] reported no significant effect. Atiyet [16] emphasized that forced financing significantly contributes to economic value added (EVA). Financial statements - income statements, balance sheets, cash flow statements, and changes in equity - are essential tools for management and investors. These statements support informed decision-making but are often complex and subject to interpretation, particularly when fraudulent practices occur. Predicting stock returns remains difficult due to market volatility and data uncertainty, as noted by Welch and Goyal [17], with newer forecasting methods such as Bayesian models [18] and extreme value theory [19] offering limited improvements.

The research gap identified lies in the limited exploration of the combined effects of financial statement fraud, accounting profits, cash flows, and financing decisions on stock returns within Pakistan's corporate context. Financial statements are critical in investment and lending decisions, offering insights into a company's financial health and future profitability [4]. However, as Habib [20] suggest, financial misreporting undermines managerial efficiency and investor confidence. Despite regulatory efforts by the Securities and Exchange Commission (SEC), manipulation of financial accounts continues to be a concern, influenced by corporate incentives and weak enforcement mechanisms. Therefore, this study aims to fill the gap by analyzing these key financial factors collectively, contributing to a better understanding of their impact on stock performance in Pakistan.

2. Literature Review

Stock performance timing refers to the degree to which a company's returns move with industry or market-level returns. Piotroski and Roulstone [21] found that informed insiders, institutional investors, and financial analysts impact stock synchronization. Higher analyst activity increases stock return co-movement by disseminating company-specific information broadly, whereas insider trading introduces more firm-specific information, reducing synchronization [6]. While insider trading strengthens private information flow, analysts push stocks toward greater market alignment.

Theoretical perspectives on accounting have evolved significantly, reflecting changing priorities in both business and society. Early frameworks, such as the residual interest theory introduced by

Staubus in 1959, centred on the interests of shareholders as the primary beneficiaries of financial reporting. This theory positioned shareholders as residual claimants entitled to a company's remaining assets after all obligations were settled, a view reinforced by Newlove and Garner [22], who conceptualized liabilities as deductions from total assets, effectively framing them as "negative assets." Such approaches prioritized shareholder wealth maximization and treated accounting as a tool to serve capital providers, emphasizing metrics like net income and equity value.

By the mid-20th century, this narrow focus began to broaden. Suojanen's social theory of accounting (1954) challenged the shareholder-centric model by arguing that corporations have responsibilities extending beyond owners to include employees, governments, creditors, customers, and the broader public. This perspective acknowledged the interconnectedness of businesses and society, advocating for accountability in areas like fair wages, environmental stewardship, and ethical governance. Subsequent scholars, including Crowther [23], built on this foundation, emphasizing the need for financial reports to reflect both profitability and social and environmental impacts. For example, it is highlighted how companies could use disclosures to demonstrate contributions to community development, while Kam explored linkages between corporate social responsibility (CSR) and long-term financial performance.

These theoretical shifts laid the groundwork for modern financial reporting standards integrating stakeholder considerations. Initiatives like the Global Reporting Initiative (GRI) and the International Integrated Reporting Council's (IIRC) framework emerged, requiring companies to disclose environmental, social, and governance (ESG) metrics alongside traditional financial statements. However, this evolution has not been without tension. Critics argue that expanding accounting's scope risks diluting its objectivity, as quantifying social contributions (e.g., carbon footprint reduction and employee welfare programs) often involves subjective judgments. Meanwhile, proponents assert that holistic reporting aligns with sustainable business practices, fostering trust among investors and the public.

Financial statements are essential tools for investors, offering structured insights into a company's resources, earnings, and liabilities Ohlson [24]. In Nigeria, financial reporting is governed by local standards aligned with international frameworks [25]. However, issues such as outdated historical cost practices, variations in global standards, and complex disclosures limit their usability, especially for individual investors. Source validity, or trust in financial statements

based on origin, is crucial for investor confidence, highlighting the need for independent and respected auditing [26].

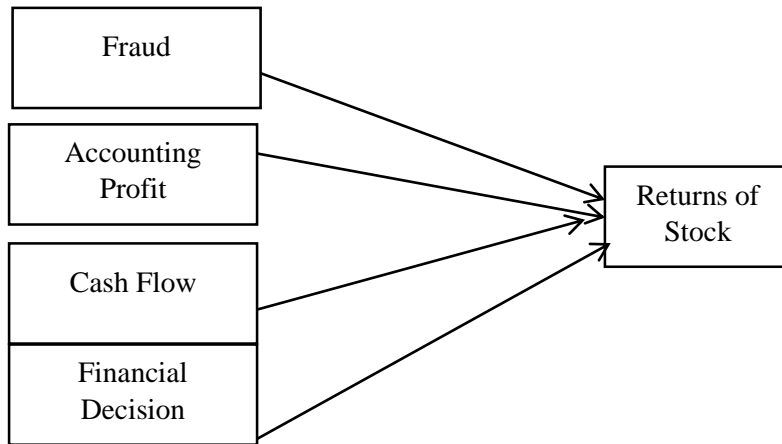
The relationship between accounting profit and stock returns is complex. While accounting earnings typically provide useful indicators for stock performance and investor decision-making [13, 27], out-of-sample evidence often challenges the predictive power of earnings data [17]. Studies also show that cash flows - particularly operating and investing cash flows - carry predictive value for stock returns [28]. However, speculative cash flows sometimes negatively affect returns, suggesting investors view risky investments cautiously [29].

Financial statement fraud, whether deliberate or arising from oversight, continues to pose significant risks to global financial systems. Intentional misstatements, often driven by motives such as inflating earnings to meet performance targets or securing executive bonuses [30], represent a calculated effort to deceive stakeholders. For instance, Erickson, Henlon [31] documented cases where managers manipulated revenue recognition or understated liabilities to artificially boost stock prices, enabling personal gains through stock option exercises. Conversely, unintentional errors frequently stem from inadequate internal controls, such as poorly designed reconciliation processes or insufficient oversight of financial reporting workflows [32]. While not malicious, these mistakes still distort financial health assessments and erode stakeholder confidence.

Scholars like Palmrose, Richardson [33] stress the critical importance of distinguishing between fraud and error during audits or investigations. Misclassifying intentional fraud as a mere error - or vice versa - can lead to misguided regulatory responses, ineffective corrective measures, and unjust legal consequences. For example, a restatement due to fraud typically triggers severe regulatory penalties and reputational damage, whereas an error might only necessitate procedural adjustments. Beyond outright fraud, researchers highlight subtler forms of manipulation, such as earnings management through selective accounting choices. Perols and Lougee [34] illustrate how firms might exploit permissible accounting flexibility, like altering depreciation methods or reserve estimates - to smooth earnings or meet analyst forecasts without technically violating standards. Karjalainen [35] further notes that such tactics, while legal, can mislead investors by obscuring true financial performance, creating an “ethical gray area” in financial reporting.

The consequences of misrepresentation extend beyond individual firms. Widespread fraud or pervasive errors can trigger systemic distrust, leading to capital flight, increased financing costs, and broader market instability. Historical examples, such as the Enron scandal, demonstrate how fraudulent reporting can cascade into industry-wide crises. Meanwhile, unintentional errors in high-profile firms may fuel skepticism about financial disclosures, prompting investors to demand higher risk premiums. To mitigate these risks, regulators emphasize stronger internal controls, auditor independence, and transparency in accounting policies. However, the evolving complexity of financial instruments and globalization of supply chains continue to challenge detection efforts, underscoring the need for ongoing innovation in audit methodologies and corporate governance frameworks.

2.1 Theoretical Framework



3. Research Methodology

The research includes public/private cement firms' data on their official sites and PSE. However, the sample for the study consists of ten firms from Pakistan's cement sector. All data used in this research is only secondary data. The data was collected from annual reports. The source for collecting data is Pakistan Stock Exchange (PSE) and the company's official websites. The data for selected variables were extracted from the Cement industry's annual reports from 2010 to 2020.

3.1 Financial Statement Fraud

The data was collected on a sample of cross-sections from 2010 to 2020 to observe the effect of selective meetings on the model of accounting fraud. Double-coded factor 1 for financial statement fraud, 0 for all cases, DAcc, Kothari, Leone [36].

Some researchers [37] have found that the dual factor demonstrating the existence of fraud is the largest and most measurable and can clarify a fraction of total income. This variable is dichotomous and subjective. If the company is a victim of financial statement fraud, it takes a value of 1. Otherwise, it is set to 0.

FRAUD = 1 if the firm has committed fraud in the financial statements.

FRAUD = 0 otherwise

3.2 Returns of Stock

A stock's return is the increase in cost divided by the stock's first cost. The main part of the inventory return recipe numerator is how much the value has expanded ($P_1 - P_0$). The denominator of the method for calculating a stock's total return is the first cost of the stock used because it is the first contribution amount.

$$Total\ Stock\ Return = \frac{(P_1 - P_0) + D}{P_0}$$

$P_0 = Initial\ Stock\ Price$

$P_1 = Ending\ Stock\ Price(Period\ 1)$

$D = Dividends$

3.3 Accounting Profit

Accounting profit is the total compensation to an organisation and is determined by subtracting expenses from revenue in accordance with generally accepted accounting principles (GAAP).

Accounting profit was extracted from companies' income statements.

3.4 Cash Flow

Operating Cash Flow (OCF) is used as a proxy of cash low. OCF is the amount of cash generated by the regular operating activities of a business within a specific period. Operating cash flow can be calculated as:

Operating cash flow = Net income + non-cash expenses + increase in Working Capital

3.5 Financing Decision

The company's finance composition choice is referred to as the financing decision [38, 39]. The debt-to-equity ratio is used in this study to assess the financing decision's leverage (DER). The choice of finance is computed as:

$$\text{Financing decision (DER}_t\text{)} = \text{Total Debt}_t / \text{Total Equity}_t$$

4. Analysis

4.1 Descriptive Statistics

Descriptive stats are used in reviews to explain the underlying disposition of information. It provides examples and brief descriptions of the tasks. Together with the investigation of simple illustrations, they essentially constitute the premise of any quantitative information investigation. The below table shows the results of the descriptive statistics of this study.

Table 1: Descriptive Statistics

	STOCK RET	ACC FRAUD	ACC PROFIT	FIN_ DECISION	CASHFLOW
Mean	-0.068463	0.356757	2025606.	5.812033	2911311.
Median	0.005832	0.000000	848598.0	0.802650	1403483.
Maximum	1.366559	1.000000	37250757	71.24000	26357744
Minimum	-3.736501	0.000000	-98777041	0.079598	-8724847.
Std. Dev.	0.626288	0.480342	9240394.	13.93564	4618517.
Skewness	-2.016204	0.598040	-6.780434	3.002760	2.145285
Kurtosis	11.11142	1.357652	79.63568	11.23199	8.661375
Jarque-Bera	632.5101	31.81935	46688.79	800.3707	388.9637
Probability	0.000000	0.000000	0.000000	0.000000	0.000000
Sum	-12.66556	66.00000	3.75E+08	1075.226	5.39E+08
SumSq. Dev.	72.17153	42.45405	1.57E+16	35733.20	3.92E+15
Observations	185	185	185	185	185

4.2 Hausman Test

Hausman test was applied to choose an appropriate test based on fixed and random effects. The null hypothesis of the Hausman test is H_0 : Random Effect regression, which is an appropriate technique. The Null_Hypothesis can be accepted or rejected based on probability value. Therefore, the Hausman test is applied, and the results are given below:

Table 2: Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	35.989147	4	0.0000

Period random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
ACCOUNTINGFRAUD	-0.070966	-0.074108	0.000228	0.8351
ACCCOUNTINGPROFIT	-0.000000	-0.000000	0.000000	0.2273
CASHFLOW	-0.000000	-0.000000	0.000000	0.1912
FINANCING_DECISION	-0.003036	-0.000277	0.000000	0.0000

Period random effects test equation:

Dependent Variable: STOCKRETURNS

Method: Panel Least Squares

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.007371	0.072457	-0.101734	0.9191
ACCOUNTINGFRAUD	-0.070966	0.096031	-0.738990	0.4609
ACCCOUNTINGPROFIT	-3.29E-09	5.02E-09	-0.655212	0.5132
CASHFLOW	-3.94E-09	9.91E-09	-0.397470	0.6915
FINANCING_DECISION	-0.003036	0.003194	-0.950331	0.3433

The null hypothesis is rejected because the probability value of 0.000 in the table above is less than the threshold of 0.05. As a result, regression analysis between the observed independent and dependent variables cannot be performed using random effect regression. For this reason, the fixed effect is suitable for examining the causal relationship between the observed independent factors and stock returns.

4.3 Fixed Effect

Dependent Variable: STOCK RETURNS

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ACCOUNTINGFRAUD	-0.184815	0.209592	-2.773919	0.0401
ACCCOUNTINGPROFIT	0.247214	0.344009	3.372302	0.0171
FINANCIAL DECISIONS	0.361930	0.508012	4.070908	0.0043
CASHFLOW	-0.212108	1.626-08	-1.120050	0.2643
C	0.028109	0.095457	0.294464	0.7688

The results of the hypotheses are given below:

4.4 H₁: Financial Statement Fraud has a Significant Impact on Returns of Stock.

The value of the coefficient for this hypothesis is -0.184815; the value of the coefficient shows that there is a negative causal relationship between financial statement fraud and a firm's profitability, which means that when financial statement fraud increases, it causes to reduction in firm's profitability however this relationship is not significant. The probability value for this hypothesis is 0.0401; therefore, we cannot reject the null hypothesis for this relationship. The value of t-statistics is -2.77. We can conclude that this model is significant in terms of both parameters, probability value, and t-statistics. Therefore, we cannot accept the Null_Hypothesis resultantly, the alternative hypothesis is accepted, and the Null_Hypothesis is rejected for a causal relationship between financial statement fraud and firm's profitability. The results of the study show that financial statement fraud negatively impacts stock returns.

4.5 H₂: Accounting Profit Significantly Impacts the Returns of Stock.

The probability value for the relationship between accounting profit and returns of stock is 0.017 and this value is less than critical value 0.05, which means that accounting profits significantly impact stock returns. Also, the value of the coefficient for this relationship is 0.247214. This positive coefficient value indicates that a unit increase in accounting profits brings a 0.24 unit increase in stock returns. The results show that accounting profits significantly positively impact stock returns in Pakistan.

4.6 H₃: Cash Flow Shows a Significant Impact on Returns of Stock.

The above table shows that the probability value for the relationship between cash flows and returns of stock is 0.264, and the value of t-statistics is -1.120050, and both values confirm the insignificant relationship. The coefficient value for this relationship is -0.21208 and shows the negative relationship between cash flow and stock returns. Hence, cash flow has a negative but insignificant impact on stock returns.

4.7 H₄: Financial Decision has a Significant Impact on Returns of Stock.

The financial decision impacts on returns of stock with a significance value of 0.0043. Similarly, the t-stat value 4.070908 confirms that financial decisions significantly impact stock returns. The value of the coefficient for the causal relationship between financial decisions and returns of stock is 0.361930. This positive value explains that a unit increase in financial decisions brings a 0.36 unit increase in stock returns. The above discussion clearly explains a significant positive relationship between financial decisions and stock returns.

This research concludes whether the experiment or survey results support or contradict the original hypothesis. In this research, three out of four hypotheses are supported. In other words, Accounting fraud, profits, and financial decisions significantly impact stock returns. On the contrary, the cash flows show an insignificant impact on stock returns, and this hypothesis fails to be accepted.

5. Findings and Conclusion

The value of the coefficient for this hypothesis is -0.184815. The value of the coefficient shows that there is a negative causal relationship between financial statement fraud and firm's profitability, which means that when financial statement fraud increases, it causes to reduction in firm's profitability; however, this relationship is not significant. From the results, the study finds that financial statement fraud negatively impacts stock returns.

The probability value for the relationship between accounting profit and returns of stock is 0.017 and this value is less than the critical value of 0.05, which means that accounting profits significantly impact stock returns. Also, the value of the coefficient for this relationship is 0.247214. This positive coefficient value indicates that a unit increase in accounting profits brings a 0.24 unit increase in stock returns. The results show that accounting profits significantly positively impact stock returns in Pakistan. Accounting profit significantly impacts stock returns.

The probability value for the relationship between cash flows and returns of stock and the value of t-statistics both confirm the insignificant relationship. The coefficient value for this relationship is -0.21208 and shows the negative relationship between cash flow and stock returns. Hence, cash flow has a negative but insignificant impact on stock returns.

The financial decision impacts the returns of stock with significant value. Similarly, the t-stat value also confirms that financial decisions significantly impact stock returns. The coefficient value for the causal relationship between financial decisions and stock returns is positive. This positive value explains that an increase in financial decisions increases stock returns. The above discussion clearly explains a significant positive relationship between financial decisions and stock returns.

The findings show the importance of establishing strong internal controls when planning financial statements. This allows organisations to recognise control at an early stage. Improving internal controls is essential in key regions. Therefore, internal auditors must examine the system identified as a designated area to recognise possible causes affecting the current situation. In a relentless and complex world, perpetrators often foster opportunities to profit through new devices and schemes, lies, and tricks. However, there is an opportunity for researchers and business pioneers alike to use new innovations and information to foster devices and cycles that will help combat the neutralising effects of fraud.

According to the fourth hypothesis, the effect of financing cash flow on stock price return is favourable. In light of these results, it is clear that the hypothesis that stock returns are strongly affected by a company's financing cash flow is correct and should be accepted. This indicates that when a company's financing cash flow is strong, investors have greater confidence in the company's future profitability potential, leading to higher share price returns.

The findings of this study are in agreement with the findings that have been published by Chu [40] and Legiman, Tommy [41], as well as the research that has been conducted by Livnat and Zarowin [42]. They argue that expanding the number of funding sources that are accessible to a company in order for the company to maintain and carry out commercial activities is to the benefit of investors and should be done whenever it is feasible to do so. This is because expanding the number of funding sources that are accessible to a company allows the company to continue to maintain and carry out commercial activities. The fact that the company now provides a greater number of opportunities for the development of firms as a direct result of the

increased availability of finance and cash flow is a positive indicator for potential investors. Additionally, the fact that the company offers a greater number of possibilities for firms to develop is a positive indicator. A favourable response from investors drives up the stock price, leading to a rise in the stock price [43].

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