ANALYSIS ON THE IMPACT OF NON-COMPLIANCE WITH ACCOUNTING PRINCIPLES BY COMPANIES, IN TERMS OF EXTERNAL FINANCIAL AUDIT "FILTERS"

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Abstract:
In order to demonstrate that there is a direct link between compliance with accounting principles and auditor's opinion, which, of course, is „filtered" through professional judgement, the study starts from information provided by a representative medium-sized audit company located in the western part of Romania. The research starting point is represented by audit opinions expressed on statutory audit engagements for financial years ended 31 December 2008 and 31 December 2009, respectively. The study pursued the typology of audit opinions expressed for clients in portfolio during the two consecutive years and aimed to find explanations for the auditor issuing other opinions than qualified opinions on one hand, and on the other hand it aimed to establish the effects of non-compliance with accounting principles on the annual financial statements and, implicitly, on the audit opinion. Generally speaking, non-compliance with accounting principles in the preparation of the annual financial statements represents one of the elements that generate the change of the audit opinion, and the main causes for this type of behaviour from the side of audited companies are resulting from the influence of fiscal decisions, window dressing and "inadaptability" to the conditions of the economic and financial crisis. The relevance of the conclusions is based not only on the prerequisites and character of treated information, but also on their practical confirmation, by means of checking them with the involved business environment (investors, shareholders, administrators, business executives).

Key words: financial audit, accounting principles, audit opinion, financial crisis, taxation

JEL Classification: M42

INTRODUCTION

Our approach is based on actual findings of a representative audit company located in the western part of Romania. The purpose of our research is pragmatic, and aims to bring in front of practitioners, academic environment and students relevant information about non-compliance with accounting principles. We selected this topic based on considerations related to how operational management of the audit company wants to know the reasons for changing the audit opinion on one hand, and on the other hand, we intended to disseminate the findings among stakeholders. The research approach is pragmatic, starting from the representative portfolio of the audit company (member of the Chamber of Financial Auditors), by means of analysing audit reports and opinions issued for two consecutive financial years, 2008 and 2009 respectively. This has allowed us to use vertical comparatives (for the same audit client), but also horizontal comparatives (clients from the same industry).

RESEARCH COMMUNITY

First we have identified the statistical population represented by companies audited as of 2008 and 2009. Thus, the structure of client portfolio audited as of 31 December 2008, according to activity field, is presented in table no. 1:

Table 1. Structure of client portfolio audited as of 31 December 2008

Economic sector	No. of companies	Weight in total
Industry	13	26,0%
Real estate	8	16,0%
Constructions	6	12,0%
Automotive	6	12,0%
Clothing	5	10,0%
Tourism	3	6,0%
Trade	3	6,0%
Transports	2	4,0%
Other fields	4	8,0%
TOTAL	**50**	**100,00%**

Source: own processing based on data received from the audit company

We observe a significant weight of productive units – industry, real estate, constructions, automotive and clothing represent 76% of the total number of clients.

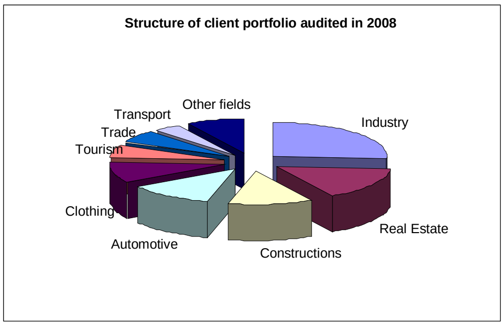

Figure no. 1 Clients audited as of 31 December 2008 according to their activity fields

As of 31 December 2009 there were 9 additionally contracted audit engagements, and 7 clients were no longer audited – thus the structure is as follows:

Table 2. Structure of client portfolio audited as of 31 December 2009

Economic sector	No. of companies	Weight in total
Industry	13	25,0%
Real Estate	10	19,2%
Constructions	7	13,5%
Tourism	5	9,6%
Clothing	5	9,6%
Automotive	5	9,6%
Trade	2	3,8%
Transport	2	3,8%
Other fields	3	5,8%
TOTAL	**52**	**100,00%**

Source: own processing based on data received from the audit company

As of 31 December 2009, the weight of real estate and tourism sectors increased – thus, the weight of productive units - industry, real estate, constructions, automotive, tourism and clothing represents 86.5% of the total number of clients.

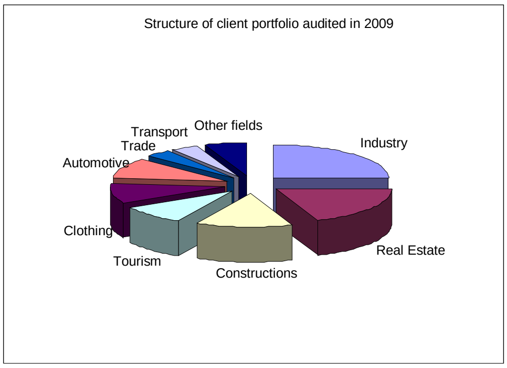

Figure no. 2. Structure on activity fields - clients audited as of 31 December 2009

AUDIT OPINION TYPOLOGY VS. ACCOUNTING PRINCIPLES

Our next objective pursued the typology of audit opinions issued by the audit company for the financial years 2008 and 2009 (Fig. no. 3).
Thus, we noticed an increase by 10 of the number of companies for which an unqualified opinion was issued, and a decrease by 8 of the companies for which an unqualified opinion was issued, while for two companies we noticed the impossibility of issuing an opinion, both at 31 December 2008 and 31 December 2009. This trend is presented in Table no. 3:

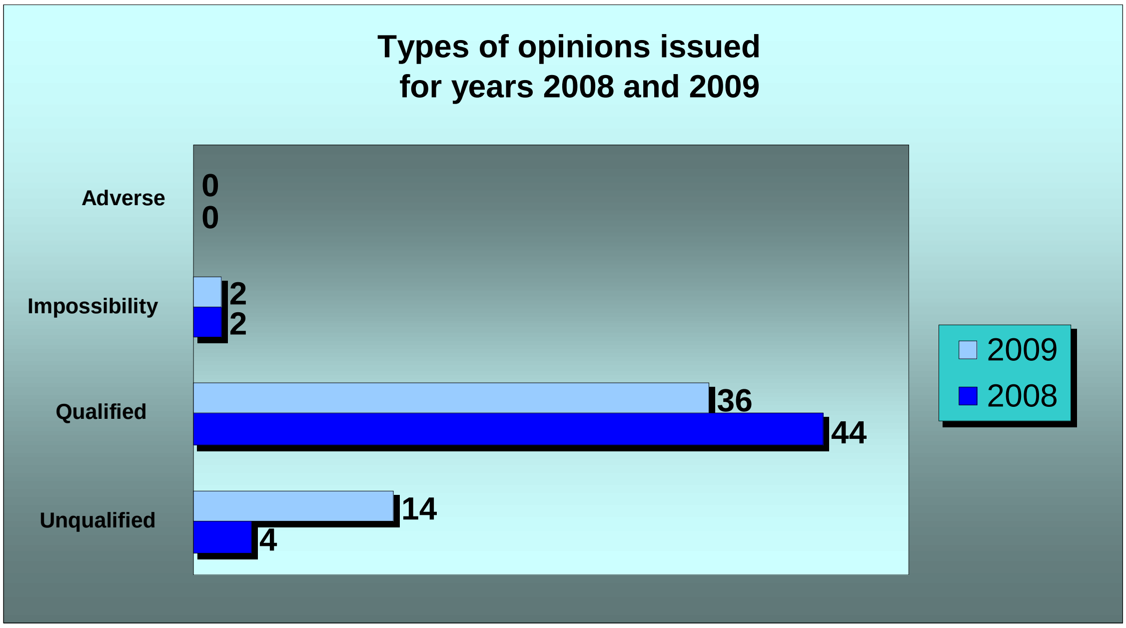

Figure no. 3. Types of opinions issued for years 2008 and 2009

Table no. 3. Trends in audit opinions typology from 2008 to 2009

	Unqualified	Qualified	Impossibility	Adverse	TOTAL
Evolution in the no. of opinions in 2009 vs. 2008	10	-8	0	0	2
out of which					
new clients	5	4	0	0	9
old clients	5	-12	0	0	-7

Further, the study pursued the evolution in the structure of clients audited in 2008, but also for new clients – where 2009 was the first audit performed by the audit company. Thus, of the 10 clients that received unqualified opinions, half were also audited in 2008 and half are new clients.
The decrease in the number of companies that received unqualified opinions (by 8) consists of four new companies that were audited for the first time as of 31 December 2009 on one hand, and the decrease by 12 of those audited in 2008 – 5 companies switched from a qualified opinion as of 31 December 2008 to an unqualified opinion as of 31 December 2009, and 7 is the number of companies for which no statutory audit has been contracted as of 31 December 2009, but which were audited as of 31 December 2008 and received a qualified opinion.
If up to this point we presented the specifics of companies that represent the basis for this case study, from now on we analysed the number of accounting principles breaches that were disclosed in statutory audit opinions, both as qualification and explanatory paragraphs. The absolute number of errors detected both for 2008 and 2009, but also the weight of affected principles in the total number of errors are presented in *Table no. 4*

Table no. 4

Principle	Errors detected in 2008	Errors detected in 2009	Weight in total errors in 2008	Weights in total errors in 2009	Deviations from weight
Continuity	11	16	5,2%	8,0%	2,9%
Method consistency	41	33	19,2%	16,6%	-2,7%
Prudence	102	96	47,9%	48,2%	0,4%
Matching	32	33	15,0%	16,6%	1,6%
Separate valuation	7	7	3,3%	3,5%	0,2%
Intangibility	0	0	0,0%	0,0%	0,0%
Netting	20	14	9,4%	7,0%	-2,4%
Prevalence of economics	0	0	0,0%	0,0%	0,0%
Materiality	0	0	0,0%	0,0%	0,0%
TOTAL	**213**	**199**	**100,0%**	**100,0%**	**0,0%**

It may be noted that the prudence principle is most often breached, both in 2008 (47.9%) and in 2009 (48.2%), followed by the method consistency principle and matching principle. The significant weight of non-compliance with the prudence principle shows the trend of accounting information producers to "dress" the financial position and performance out of various reasons: management remuneration based on entities' performances, fulfilment of performance conditions for renewing credit lines, participation in tenders or obtaining new financing from credit institutions, tax implications of depreciation recognition, which by non-deductibility creates the false impression that managers would increase the tax base, which actually has a neutral character, as expenditure recognised for accounting purposes reduces exclusively the accounting result, while the tax result stands at the same level as before any impairment recognition.

If we look closer to the issue of prudence breach, we can conclude that it is human nature to disclose a decorated image of a specific aspect. The implications on non-compliance with this principle have been treated amply in a previous sub-chapter.

Also, the tax reason is the one that led to the breach of method consistency principle, which mainly affects non-current assets that are recognised at fair value only in respect to buildings (due to how tax on buildings is established). This occurs only once in 3 years, an interval that I would call a “tax” one. In periods when real estate markets are highly fluctuating, buildings should be revaluated annually, and the sufficient regularity required by accounting regulations decreases at the level of one financial year. All other categories of non-current assets were revaluated only when the law expressly provided that, and afterwards assets entered into the patrimony are evaluated at historical costs. Thus, for the same assets category companies use two different accounting treatments.

The breach of the matching principle appertains to creative accounting practices (Bunget, 2005) when we can have two main scenarios: if the results of the year are negative, management tends to charge more expenses to this year, although this is not appropriate, because the outcome will be the creation of hidden reserves or “occult reserves”, or, if performances are positive, but because “there is no place” for recognition of additional expenses this is delayed, hoping that results of future financial years will “bear” the costs of previous years.

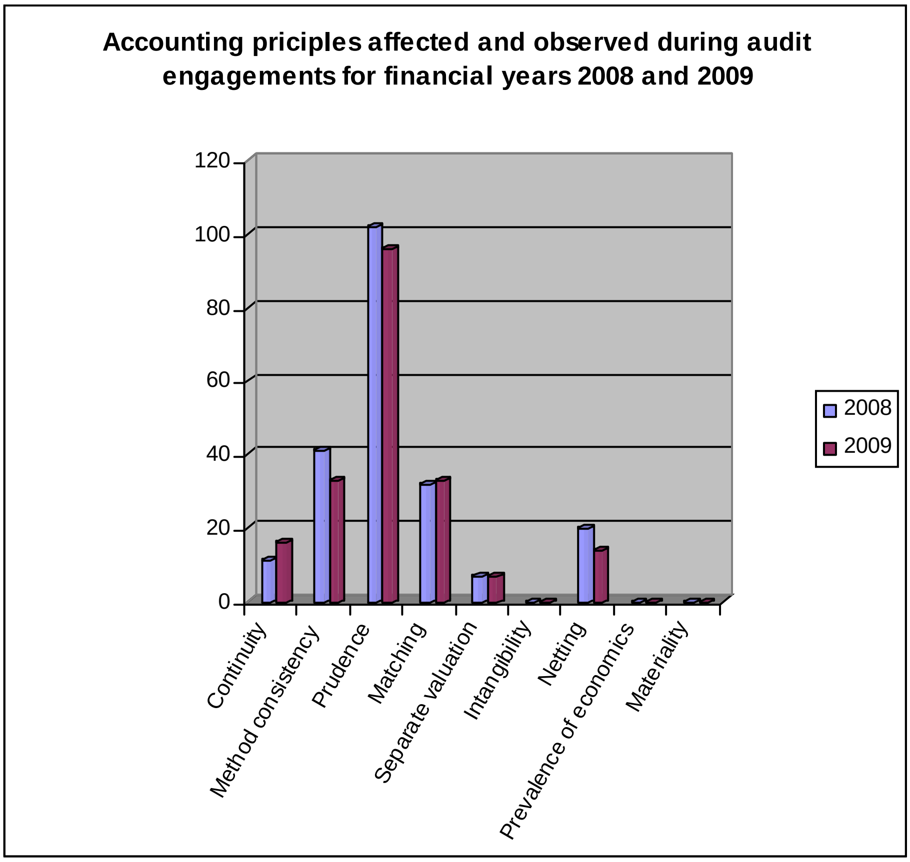

Figure no. 4. Dynamics of errors arising from non-compliance with accounting principles during financial years 2008 and 2009

Additional information is obtained by analysing the dynamics of each principle's weight. The economic and financial crisis is an important external factor that impacts compliance with accounting principles. As everybody knows, 2009 was marked by the global economic crisis broken out back in 2008, whose effects were felt in Romania during the next year, which was also fed by the political climate in late 2008 – underlined by elections – which aspect contributed to bitter hiding of as many negative economic and social issues as possible, with serious consequences for Romania's budget deficit and, implicitly, for the existence of economic entities. As a consequence, the going concern principle was most threatened by errors during financial year 2009 compared to 2008. The absolute increase of this principle's weight in total errors was of 2.8% - from 5.2% (weight in 2008) to 8% in 2009, and the relative one was of 54%.

Thus, in terms of graphics, this dynamics is presented below:

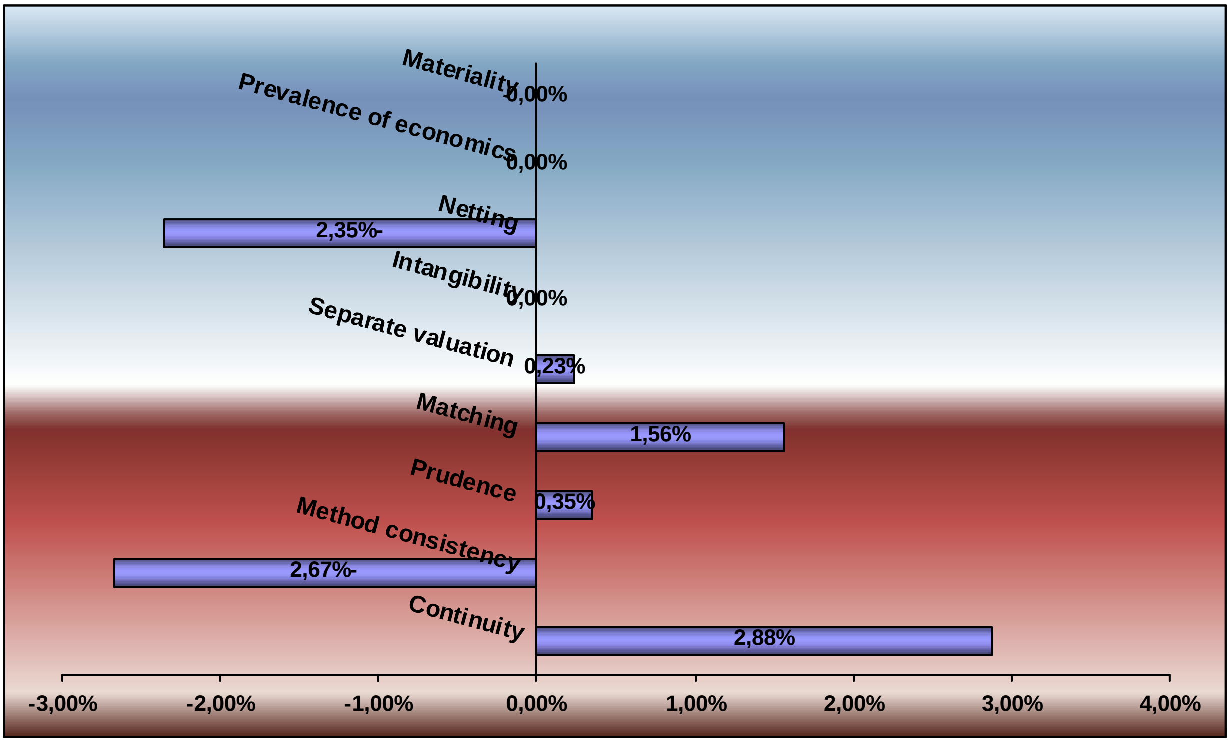

Figure no. 5. Dynamics of errors resulted from non-compliance during 2008 and 2009

The matching principle is the next principle for which we noted an error increase of 1.56%. Errors that affect prudence principle and separate evaluation of assets and liabilities principle also increased by 0.35%, and 0.23% respectively.

By contrast, there are principles for which noted errors decreased in 2009 compared to 2008: method consistency by 2.67% and netting principle by 2.35%. The explanation is that during 2009 most companies have performed the revaluation of tangible assets (considering the cyclicality of the 3 tax years discussed above on one hand, and that the last legal regulation was GD *1553/2003 on revaluation of tangible assets and assessment of fixed assets input value,* which optionally provided the revaluation possibility – the last value surplus recognised in the fiscal value; cyclicality is 2003–2006–2009). The explanation for the netting principle consists in the fact that anyway the final result is not affected, and entities' management "chose" to breach other principles with direct effect on results.

CONCLUSIONS

The analysis of information and data provided by the study allowed us to draw the following conclusions:

- ✓ The study pursued the structure of audit opinions typology for clients audited in 2008, but also for new clients – 2009 was the first year audited by the audit company. Thus, of the 10 clients that received an unqualified opinion for the 2009 financial statements, half were also audited in 2008, and half are new clients;
- ✓ The decrease by 8 in the number of companies that received an unqualified opinion consists of four new companies that were audited for the first time as of 31 December 2009 on one hand, and the decrease by 12 of those audited in 2008 – 5 companies that switched from a qualified opinion as of 31 December 2008 to an unqualified opinion as of 31 December 2009, and 7 is the number of companies for which no statutory audit has been contracted for 31 December 2009, but which were audited as of 31 December 2008 and received a qualified opinion;
- ✓ Prudence principle is most often breached, both in 2008 (47.9%) and in 2009 (48.2%), followed by method consistency principle and matching principle;
- ✓ The significant weight of non-compliance with prudence principle shows the tendency of accounting information producers to "dress" the financial position and performance, out of various reasons: management remuneration based on entities' performances, fulfilment of certain performance conditions for renewing the credit lines, participation in auctions or obtaining new financing from credit institutions, tax consequences of certain impairment recognition;
- ✓ Tax reasons led to the breach of method consistency principle. The most affected assets category is represented by non-current assets that are recognised at fair value only in respect to buildings (due to how tax on buildings is established). This occurs only once in 3 years, an interval that I would call a "tax" one. In periods when real estate markets are highly fluctuating, buildings should be revaluated annually, and the sufficient regularity required by accounting regulations decreases at the level of one financial year. All other categories of non-current assets were revaluated only when the law expressly provided that, and afterwards assets entered into the patrimony are evaluated at historical costs. Thus, for the same assets category companies use two different accounting treatments
- ✓ The economic crisis is an important external factor that impacts on compliance with accounting principles. As a consequence, the going concern principle was most threatened by errors during financial year 2009 compared to 2008. The absolute increase of this principle's weight in total errors was of 2.8% - from 5.2% (weight in 2008) to 8% in 2009, and the relative one was of 54%.

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