MASSAGING THE

RELEVANT TO ACCA QUALIFICATION PAPER P7

A survey of audit committee members attending the 4th Annual Audit Committee Issues Conference, published by KPMG in 2008[1], identified the increased risk of earnings management as a top concern. For auditors, it is certainly the case that there is an increased risk of earnings management or even fraudulent financial reporting in the financial statements of those companies affected by the global economic downturn.

THE PAST YEAR HAS SEEN TURMOIL IN THE WORLD'S FINANCIAL MARKETS. AS MAJOR ECONOMIES FALL INTO RECESSION, PRESSURE IS ON COMPANIES TO MAINTAIN PERFORMANCE TARGETS AND TO CONTINUE TO MEET SHAREHOLDERS' EXPECTATIONS.

WHAT IS 'EARNINGS MANAGEMENT'?

Earnings management occurs when companies deliberately manipulate their revenues and/or expenses in order to inflate (or deflate) figures relating to profits and earnings per share. In other words, it is when companies use 'creative accounting' to construct reported figures that show the position and performance that management want to show. Unfortunately, earnings management is not uncommon. Preparers of financial information (the finance director or financial controller, for example) are often under pressure from other members of the senior management team to present a certain level of profitability. This is especially the case in today's economic climate, when a company's revenue may have reduced significantly due to market factors, or if profit is being eroded by significant expenses arising from asset impairments or other exceptional losses.

Earnings management does not always mean that the applicable financial reporting framework has not been followed. Earnings management is often described as 'bending the rules'. It may be that the manipulation of published figures is the result of selecting an accounting policy which is allowed under the financial reporting framework, but which does not reflect economic reality. For example, changing the estimated life of a non-current asset is allowed under financial reporting standards, but if it is done purely to manipulate the depreciation charge (and therefore earnings), then it becomes an example of earnings management.

The problem for the auditor is that financial reporting standards allow a degree of flexibility in application, and all financial statements will include balances and disclosures that are subject to judgment and estimations. This means that it is sometimes difficult to decide if an accounting treatment is within accepted accounting principles, or whether the treatment is in breach of the rules – in which case it represents fraudulent financial reporting.

WHEN DOES EARNINGS MANAGEMENT BECOME FRAUD?

Fraudulent financial reporting is a deliberate misstatement in the financial statements. It can include the deliberate falsification of underlying accounting records, intentionally breaching an accounting standard, or knowingly omitting transactions or required disclosures in the financial statements. For example, deliberately not disclosing a contingent liability, or significant going concern problems, in the notes to the financial statements means that the disclosures required (under IAS 37 and IAS 1 respectively) have intentionally not been made. According to ISA 240 (Redrafted), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* this is an example of fraudulent financial reporting.

ISA 240 (Redrafted) states that 'incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to reach financial goals can be significant'. It can therefore be seen that in times of financial difficulty, such as the current economic downturn, management may feel pressurised into the non-disclosure of items that may detract from the company's performance during the year, or into the use of accounting policies which produce deliberately misstated results for the year.

Earnings management and fraudulent financial reporting are discussed more fully in an article in *student accountant* by Namasiku Liandu[2], which can be found on the ACCA website.

Sudying Paper P7?
Performance Objectives 17 and 18 are linked

FIGURES

WHAT ARE THE IMPLICATIONS TO THE AUDITOR?

Professional skepticism

ISA 240 (Redrafted) stresses the importance of approaching the audit with a degree of professional skepticism, an attitude which should be heightened if there is a suspicion of fraudulent financial reporting.

Discussion among the audit team

In accordance with ISA 315, *(Redrafted) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, ISA 240 (Redrafted) re-emphasises the fact that the audit team should have a discussion about those factors that indicate that the financial statements may be susceptible to misstatement due to fraud.

Evaluation of accounting policies

When assessing the risk of fraudulent financial reporting, particular attention should be paid to the selection and application of accounting policies. Particular attention should focus on those policies relating to complex transactions, and to subjective matters.
All accounting policies and estimates should be carefully reviewed for potential bias. The circumstances resulting in any bias may represent a risk of misstatement due to a fraudulent financial reporting.

Completeness of disclosures

In difficult economic times, management may be tempted to hide information which may raise concerns about the company's performance. The auditor must therefore consider whether all relevant information has been disclosed in the financial statements in compliance with accounting standards.

Audit report

In cases where financial statements appear to have been misstated due to earnings management or fraudulent financial reporting, the auditor should carefully consider the implications for the audit report. The problem for the auditor will be to decide whether any earnings management is within generally accepted accounting principles (and so, therefore, the financial statements are fairly presented), or whether it is so aggressive that it is in breach of accepted accounting practice and therefore fraudulent. A breach of financial reporting principles resulting from the misapplication of accounting standards will result in a disagreement and thus a potential qualification of the audit opinion.

Reporting to those charged with governance

Instances of fraudulent financial reporting should be communicated to those charged with governance on a timely basis. The relevant audit procedures necessary to complete the audit should also be discussed.

Other reporting responsibilities

ISA 240 (Redrafted) indicates that where fraud has occurred, the auditor should consider other reporting responsibilities, such as communications with regulatory and enforcement authorities. In many jurisdictions, it would also be appropriate to communicate with shareholders, for example at a general meeting of members.

IN THE CURRENT CLIMATE, AUDITORS NEED TO CONDUCT RISK ASSESSMENT AND AUDIT PROCEDURES CAREFULLY, IN ORDER TO FULLY IDENTIFY INDICATORS OF MANIPULATION, AND MAY NEED TO APPROACH FINANCIAL STATEMENTS WITH AN INCREASED DEGREE OF SKEPTICISM.

CONCLUSION

Current global economic circumstances mean that auditors face increased audit risk. Preparers of financial statements have the motive to make the published accounts appear as good as possible, and the means to do this is earnings management or fraudulent financial reporting. Auditors therefore need to conduct risk assessment and audit procedures carefully, in order to fully identify indicators of manipulation, and to gather sufficient evidence to decide whether any manipulation is the result of bending or breaking financial reporting rules, for which the ultimate consequence may be a qualified audit opinion. Auditors, as well as shareholders, may need to approach all companies' financial statements with an increased degree of skepticism in the current climate.

Lisa Weaver is examiner for Paper P7

REFERENCES

1 *Recession-Related Risks, a Top Concern for Audit Committees*, KPMG Audit Committee Institute Survey, 2008.
2 Namasiku L, *Earnings Management*, *student accountant*, April 2004.