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Research paper

Preventing profit manipulation and improving the quality of financial reporting through the audit judgement

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ABSTRACT

Purpose: The objective of this study is to assess the perception of audit professionals on the importance of adopting Accounting and Financial Reporting Standard (NRCF) 4 - Accounting Policies, Changes in Accounting Estimates and Errors and International Accounting Standard (IAS) 8 - Accounting Policies, Changes in Accounting Estimates and Errors, essentially regarding the prevention of profit manipulation practices and the improvement of the quality of financial reporting.

Methodology: A qualitative methodology was adopted by conducting structured interviews with four audit professionals.

Results: The interviewees consider that the auditor plays an important role in the application of value judgments and validation of estimates, stating that their work is a deterrent to the practice of profit manipulation. They also consider that the auditor's ethics, professional skepticism, and degree of independence contribute to an improvement in the quality of financial reporting and a decrease in profit manipulation practices.

Research limitations: The small sample size; and the limitations associated with conducting interviews were the main limitations encountered.

Originality: This study is innovative in that it gathers the opinion of auditors and chartered accountants on a very relevant matter in the accounting field, given that standards increasingly call for the application of value judgments in defining accounting policies and estimates, as well as in changing them and detecting errors.

Keywords: NCRF 4; IAS 8; Auditor; Accounting Policies; Estimates.

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1. Introduction

The objective of NCRF 4 and IAS 8 is to prescribe the criteria for selecting and changing accounting policies, and the accounting treatment of changes in accounting estimates and corrections of errors. These standards are intended to improve the relevance and reliability of an entity's financial statements and their comparability over time and with the financial statements of other entities. The application of accounting policies, the change in accounting estimates and the existence of errors should be validated and disclosed by the auditor, thus promoting an improvement in the quality of financial reporting and preventing result manipulation practices.

Given the importance that this theme assumes within the scope of accounting and auditing, this study aims to analyse the relevance of the auditor's work regarding the application of accounting policies, changes in accounting estimates and errors, essentially with regard to the prevention of result manipulation practices and the improvement of the quality of financial reporting.

The research question on which this study is based is the following: "does the auditor have a relevant position as regards the application of accounting policies, changes in accounting estimates and errors, essentially as regards the prevention of result manipulation practices and the improvement of the quality of financial reporting?".

To answer this research question, the main objective of this study was to assess the auditor's position regarding the impact of the adoption of NCRF 4 - Accounting Policies, Changes in Estimates and Errors (CNC, 2015) and IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors (IASB, 2008) on the quality of financial reporting and the prevention of result manipulation practices.

This study seeks to recognise the importance of the auditor's work in validating the value judgements present in the accounting standards, contributing to the reduction of result manipulation practices and consequent increase in the quality of financial statements.

As a study methodology, structured interviews were carried out with a group of Statutory Auditors (ROC) and Auditors (non-ROC).

This paper begins with a literature review of accounting standards on the application of accounting policies, changes in estimates and errors (NCRF 4 and IAS 8). This is followed by a theoretical analysis of auditing, the quality of financial reporting and the

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manipulation of results. Next, we move on to the empirical study, with the presentation of the research question, the objective, the sample, the methodology and, finally, the discussion of the results obtained. The conclusions, limitations and proposals for future research are presented at the end of the study.

2. Literature Review

2.1 Accounting policies, changes in estimates and errors

Accounting policies, as defined of NCRF 4 and IAS 8, "are the specific principles, bases, conventions, rules and practices applied by an entity in the preparation and presentation of the financial statements" (§5, NCRF4; §IAS 8). Under the terms of §7-19 of NCRF 4 and §13-31 of IAS 8, it is necessary to select and apply accounting policies consistently and conscientiously, despite the fact that, in some situations, they arise from management judgements.

Furthermore, it is also necessary to understand what causes a change in an accounting policy. Its application is, as a rule, retrospective, which results in the adjustment of each component of equity capital affected, for the earliest period presented, as if the new adopted policy had always been applicable. Such procedure will lead to a restatement of previous years' financial statements.

However, retrospective application has limitations when the change in accounting policy makes it impracticable to determine the specific effects of a period, or else, the commutative effect of that same change (in accordance with § 20-24 of NCRF 4 and § 23-27 of IAS 8). Therefore, when such impracticability is detected, the change in accounting policy should be applied as from the earliest practicable date.

Accounting estimates can be defined as an approximate carrying amount of an asset or a liability, when it is not possible to measure its value accurately, due to uncertainties inherent to business activities or due to the lack of information. The change in an estimate has prospective application, i.e. the change in estimate must be included in the determination of the net profit in the period in which the change occurs, and/or in the period in which it occurs and following periods, if it affects both.

An accounting estimate is subject to judgement by those who use it. Estimates may be required (in accordance with §25 of NCRF 4), in the following situations:

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a) Bad debts (from accounts receivable) - which refers to NCRF 27, as regards impairment in financial instruments;
b) Obsolescence of inventories - which refers to NCRF 18, as regards impairment of inventories;
c) Fair value of financial assets or financial liabilities - referring to NCRF 27;
d) The useful life of or expected pattern of consumption of the future economic benefits embodied in depreciable assets - referring to §51 and 60 to 61 of NCRF 7 and to NCRF 12;
e) Obligations in respect of guarantees - referring to NCRF 21, addressing provisions.

The use of reasonable accounting estimates does not affect the reliability of the financial statements (§33, IAS 8; §26, NCRF 4; §84 of the Conceptual Framework of the Accounting Standards System).

Prior period errors, in accordance with paragraph 5 of IAS 8 and NCRF 4, is the omission and misstatement in the entity's financial statements, which may be for one or more prior periods, arising from a failure to use, or misuse of, reliable information that was available when financial statements for those periods were authorized for issue. Such information could reasonably be expected to have been obtained and considered in the preparation and presentation of those financial statements.

When facing situations of error, we can have immaterial errors made intentionally, or material errors, whether intentional or not. An error is retrospective in application unless it is impracticable to determine the specific effects of a period or the cumulative effect of the error.

2.2 Audit and Financial Reporting

Financial reporting, according to the Accounting Standards System, is essentially done through the disclosure of financial statements, which are a representation of the financial position and financial performance of the entity that issues and discloses them. The financial report has an essential role in the decision making of the users of the financial statements, since it is through this that they obtain all the necessary and useful information to justify the decisions taken (Costa, 2017; Sitanggang, Karbhari, Matemilola & Ariff, 2019).

The quality of the financial report depends on the quality of the information contained in the financial statements that entities prepare in the process of closing the accounts of each economic year. Therefore, and since the primary objective of the financial statements is to provide and disclose information to the various users, it is of high importance that the financial statements convey the quality and true and fair view of the financial information (Martínez-Ferrero, Garcia-Sanchez & Cuadrado-Ballesteros, 2013; Sousa, 2017; Baah and Fogarty, 2018).

In accordance with §10-11 of International Standard on Auditing (ISA) 700 (IAASB, 2016), the auditor should form an opinion on whether the financial statements are prepared, in all material respects, in conformity with the applicable financial reporting framework. To form that opinion, the auditor must also obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to error or fraud.

The audit aims to assess the assertions underlying the financial statements through the expression of an opinion of an independent and competent professional on the financial statements of an entity (Costa, 2017). Thus, audit work is a process of gathering evidence to attest the assertions made by the management, contained in the financial statements of an entity, to evaluate them, based on the accounting standards and other references, communicating the conclusions obtained to the users of the financial information (Almeida, 2017).

Moreover, the existence of an external auditor also influences the quality of the audit, essentially through its degree of independence in validating the financial statements (Habbash & Alghamdi, 2017).

According to DeAngelo (1981) and Arruñada (2000), the quality of the audit services is defined as the joint probability of the auditor to detect errors and possible frauds, when examining the financial statements developed by the entity (technical and professional competence), and the ability of the same to report these events through its opinion in the audit report (independence).

For Ito, Niyama, and Mendes (2008), the quality of the audit services rendered is directly related to the auditor's professional competence, as well as his degree of independence in relation to the audited entity and the compliance with the auditing and accounting standards imposed by the regulatory entities.

Willekens, Dekeyser, Bruynseels, and Numan (2023) infer audit quality from two measures of financial reporting quality: (a) the level of absolute abnormal accruals, and (b) the incidence of financial statement restatements. The authors argue that the competition among auditors may lead to higher audit quality, and the audit quality is affected by an industry leader's industry market share dominance over its competitors rather than by industry specialization per se.

An audit is of quality when it allows the auditor to issue an opinion which ensures that the information contained in the financial statements is true and appropriate as to the company's financial position, as well as the results of its operations and cash flows on the date and period to which they were subject to evaluation (Costa & Moreira, 2010). For Baah and Fogarty (2018), audit quality refers to the extent (degree) to which an auditor's independence, integrity and objectivity affects financial statement quality. Companies demand higher audit quality with reference to the experience and reputation gained. However, according to DeAngelo (1981), audit quality may still be related to the size of the audit firm, as the auditor's work is not independent of the size of the audit firm. While an auditor from a large audit firm (Big Four) has the same technological capabilities as an auditor from a smaller audit firm, the penalties for an auditor in a Big Four team will be more significant than for an auditor in a smaller firm.

2.3 Practices of results manipulation

The manipulation of results has been assuming a very relevant role in the preparation of financial statements, and it is important to prevent and ensure that they are free from such practices. There are authors who argue that the use of accounting estimates by managers in the recognition of items and in the preparation of financial statements has become significant. When evaluating the factors related to the process of auditing the accounting estimates, Bratten, Gaynor, McDaniel, Montague and Sierra (2012) concluded that the complexity of the financial reporting standards, in addition to hinder the auditor's work, negatively affect their performance. This happens due to the existence of uncertainty and subjectivity, which consequently may lead to an increase in the occurrence of result manipulation practices. In addition, the difficulty and risk in auditing accounting estimates is also mentioned, since there is an inability on the part of the auditor to effectively assess the assumptions used by the administration.

The role of the auditor in detecting and deterring profit manipulation practices and improving the quality of financial reporting has proved essential. Many users of financial statements base their decisions on the opinion issued by the auditor, giving it the necessary credibility and confidence to make decisions with less risk.

One of the ways of studying the quality of the audit performed by auditors is through the analysis of the manipulation of results. Although it is extremely difficult to sustain its existence, since it is difficult to estimate the results before an alleged manipulation, it is necessary, in the first instance, to identify which incentives lead the companies' managers to manipulate the results and to verify whether the accounting choices adopted by them are in conformity with these incentives (Healy & Wahlen, 1998).

The theme of results management has been much studied, namely at the level of behaviours and motivations that lead either to a management within what is allowed in the normative flexibility or to a management that manipulates the results with consequences in what concerns accounting frauds. There is, therefore, a growing concern to restore investor confidence through greater transparency in financial reporting. The role of the auditor is recognised as essential in this process (Lopes, 2018).

The study of Lopes (2018) analyses the relationship between profit manipulation and audit quality, in a set of 4723 Portuguese companies between 2013 and 2015. The results revealed that there is a relationship between audit quality and earnings manipulation.

Imen and Anis (2021) in the study on the relationship of modified audit opinions and the earnings management, found that earnings management increases the likelihood of receiving a modified audit opinion, and then firms receiving modified audit opinions manage earnings more than those receiving clean opinions.

The relationship between independence of external auditor and the detection of manipulation in financial statements was studied by Mahami and Mouloudj (2020). The results revealed that the independence have no statistically significant effect on detection of manipulation, i.e., the auditor independence is necessary, but not sufficient to detect manipulation in financial statements.

According to Salas, Blake, and Gutiérrez (1996), there are several ways in which results manipulation practices may be applied in a company, with the purpose of having the accounting reflect the image that managers want, such as the choice of accounting methods to be applied and the recording of fictitious transactions. However, the same authors refer that accounting estimates are also a form of result manipulation, since there are operations that depend on managers' judgements, and they may choose the estimates that are most convenient for them.

Christensen, Huffman, Lewis-Western and Scott (2021) refer that although the manipulation of results has a negative connotation, not all activities arising from it are harmful to users of financial statements, since managers can use the flexibility of accounting standards in a non-opportunistic way.

Fraud consists of an intentional distortion of the financial statements by managers, with the purpose of changing the stakeholders' opinion in order to benefit themselves or the entity (Mulford & Comiskey, 2002).

According to Dechow and Skinner (2000) and Nunes (2014), the manipulation of results and fraud differ in a main aspect. The manipulation of results is within the limits of flexibility allowed by the accounting standards with the purpose of deceiving the users of the financial statements about the financial position, while fraud configures a manipulation that exceeds (violates) the conservatism, the discretion, and the most aggressive accounting criteria, with the purpose of misleading the users of the financial statements.

However, it is important to distinguish between practices of results manipulation and fraudulent practices, so that there is scrutiny in relation to the manipulation practices that are practiced through judgements made by managers and those that result from the application of estimates that enable the purposes of the entity's business to be achieved.

There is no specific standard concerning the manipulation of results that allows guidance to the auditor regarding these practices, however, the auditor should act in accordance with ISA 240 (IAASB, 2009), which in §10 establishes three objectives, namely identifying and assessing the risks of material misstatement of the financial statements due to fraud, obtaining sufficient and appropriate audit evidence as to the risks of material misstatement due to fraud and, finally, the auditor should also respond appropriately to fraud or suspicion of fraud identified during the audit work.

The use of estimates is the basis of the practice of result manipulation because accounting estimates are subjective and depend on the judgements of the managers. Therefore, it becomes necessary for the auditor to assess the risks of material misstatement that may be associated with the degree of uncertainty of the accounting estimates adopted (ISA

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540, IAASB, 2018). The existence of uncertainty and subjectivity in the accounting work for the preparation of financial statements affects the auditor's work, to the extent that the auditor may have difficulty or be unable to effectively assess the assumptions used by management for the preparation of financial statements (Griffith, Hammersley & Kadous, 2015; Public Company Accounting Oversight Board, 2017).

ISA 540 (IAASB, 2018), in its paragraph 21, mentions the auditor's duty to review the judgements and decisions made by management in applying accounting estimates to identify management's lack of independence, with a view to ensuring that accounting estimates have been correctly used, and that there is no distortion in the financial information.

The most effective application of the auditor's professional judgement, especially in more complex accounting contexts, requires the auditor to adopt critical thinking, with a less mechanistic mindset and a more systemic mindset (Bucaro, 2019).

3. Methodology

The use of accounting estimates has become a practice in accounting, deserving special attention by the auditor. This attention is justified by the fact that accounting estimates and accounting policies are based on the application of value judgements, which can significantly affect the financial position and results of a company. These judgments, applied in environments of risks and uncertainties, may lead managers to incur in practices of results manipulation (Tavares & Carvalho, 2018).

This study adopts a qualitative methodology, through interviews. A non-statistical, intentional, and non-random sample of four professionals was used: two of them working as statutory auditors and two working as auditors (not statutory auditors). This categorisation was intentional, with the purpose of verifying whether there is any difference in their perspective when faced with the questions posed. The interviewees were selected by personal knowledge.

The interviewees were contacted by email in October 2022, and the interviews were conducted through the Zoom chat platform. The duration of each interview did not exceed 30 minutes. None of the interviews conducted were recorded. The information was transcribed by the researcher. Regarding the identification of the interviewees, only their professional situation and gender are disclosed.

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To conduct the interviews, a set of seven questions was outlined, which centralise the themes addressed throughout this study, namely the application of value judgements, the usefulness of auditing for decision-making on the part of the users of the financial statements, the theme of profit and loss manipulation, the principles that the auditor must comply with (ethics and independence), the use of accounting policies and estimates, as well as the role of the auditor in the validation of these and in the prevention of profit and loss manipulation practices. The set of questions used for the development of these interviews are shown in the table below.

Table 1. Interview questions

Questions
1. Do you consider the auditor's role in the application of value judgements related to accounting policies and estimates (NCRF4 and IAS8) to be relevant?
2. Do you consider that the auditor's work contributes to the usefulness of the Financial Statements for the decision-making of users?
3. Do you consider that auditing has an inhibiting role in creative accounting practices, profit manipulation and fraud practices?
4. Do you consider that greater ethical commitment on the part of the auditor leads to greater detection of the manipulation of results?
5. Do you consider that there are differences in a quality audit depending on the degree of independence of the auditor, internal or external?
6. Do you consider that there can be manipulation of results using accounting estimates?
7. Do you consider that the auditor has an important role both in validating the estimates and in preventing such practices of results management, and in improving the quality of auditing?

Source: Own elaboration

4. Results and discussion

The characterization of the interviewees is presented in the following table.

Table 2. Characterization of the interviewees

Interviewee	Professional status	Gender
1	Statutory Auditor (ROC)	Female
2	Statutory Auditor (ROC)	Female
3	Auditor (non-ROC)	Male
4	Auditor (non-ROC)	Female

Source: Own elaboration

Within the scope of the relevance of the auditor's role in validating accounting estimates and accounting policies for increased perceived reliability by users of financial statements, interviewees agreed with the fact that the auditor is attributed a very important role in applying judgements related to accounting estimates and policies. It was also

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unanimous among the interviewees that the auditor provides an important contribution to make the financial statements useful for users' decision-making.

The fact that accounting is based on accounting estimates and that accounting estimates play a much more important and frequent role in the preparation of financial statements was highlighted, and the auditor must address the factors that underpin the estimates (as mentioned by Bratten, Gaynor, McDaniel, Montague & Sierra (2012).

The importance of auditor characteristics and knowledge was noted, namely knowledge of the client's standards and business. In addition, the auditor should have a keen capacity for critical analysis and a critical sense of risk, so that he or she is able to assess the underlying judgements in the estimates presented to him or her. The auditor should also consider that the use of value judgements can lead to the manipulation of results or fraudulent financial reporting, and it is important to be able to obtain the grounds for the value judgements applied.

Although the auditor's work is considered as an added value in the decision-making process of the users of financial statements, not all users of financial statements need the auditor's opinion to make decisions. Consensus was reached that "the function of auditing and the main objective of the auditor is to convey additional comfort to the users of the financial statements and greater credibility of the information disclosed".

The interviewees further mentioned that "the auditor's role in applying judgements related to accounting estimates and accounting policies is important. Validation by the auditor gives greater credibility to the financial statements". In this sense, the auditor's work is an important factor in the decision-making of the users of the financial statements (Salas et al., 1996); Griffith et al., 2015).

Regarding auditor ethics and the inhibiting role in practices of results manipulation or fraud, the interviewees referred that "the ethical principle of the auditor is not related to the ability to detect result manipulation practices". They also added that "the ethical principle of professional scepticism should be practised throughout the audit process, and the auditor should validate all information in order to obtain a degree of confidence in it". In addition, professional scepticism is an ethical principle that should be reinforced when there is greater pressure from the users of the financial statements, shareholders, or managers towards the company (as referred by Cunha, 2013 and Freitas, 2020).

The ethical principle of independence was also mentioned as "a fundamental principle of auditing". These ethical principles are essential for the prevention of result manipulation, creative accounting, or fraud practices. However, it is important for the auditor to be able to differentiate between the manipulation of results and fraud (Dechow & Skinner, 2000; Nunes, 2014). The interviewees also considered that "systematic monitoring, the existence of rigorous internal control procedures and the presence of an external auditor may be inhibiting factors of result manipulation practices".

Regarding the independence of the auditor, the interviewees claimed, "it is important that the auditor performs its work with the utmost professionalism". This represents complying with the ethical requirements mentioned in the Code of Ethics of the Order of Chartered Accountants and maintaining a standard of quality in their services, following standards such as ISQC 1, ISA 220 (IAASB, 2009) and the Code of Ethics of the International Ethics Standards Board for Accountants.

They focused on the independence of the auditor analysed by the presence of an external auditor or an internal auditor. They consider that the work of the internal auditor differs from the work of the external auditor. As interviewee 1 states "The internal auditor aims to add organisational value by improving the company's internal procedures, ensuring that they are complied with as outlined by the management body, reporting possible deficiencies/fragilities to the supervisory body." The work of the external auditor "is more focused on issuing an assertive and appropriate opinion on accounting and tax information" (interviewee 3). They also consider that there is greater independence of the external auditor in relation to the internal auditor. Even so, both the external auditor and the internal auditor should be governed by the same principles, namely their independence, as reported by, among others, Costa (2017), Habbash and Alghamdi (2017), Baah and Fogarty (2018), Mahami and Mouloudj (2020).

The use of estimates and judgements is a means used for the manipulation of results. It is considered by all interviewees that the increasing use of accounting estimates in financial reporting. As interviewee 2, "has high potential for the existence of manipulative practices in the accounts". The application of accounting policies, when they occur, should be clearly disclosed so that the users of financial statements are aware of the facts that gave rise to them, the conditions under which they were applied and their impacts. This disclosure promotes a higher quality of the financial statements and prevents/inhibits practices of result manipulation (Lopes, 2018)

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ISA 540 (IAASB, 2018) was referred to by all interviewees as guiding in obtaining sufficient and appropriate audit evidence on the use of accounting estimates. Specifically, interviewees 1, 2 and 4, consider that the auditor's intervention is a deterrent to the practice of profit manipulation, since, for those who prepare the financial statements, there is a perception that the accounts will be scrutinised.

Even so, they consider that it is difficult for the auditor to detect, after the accounts have been prepared, the existence of creative accounting practices and the manipulation of results and their objective. However, they consider that these practices are distinct from fraudulent practices and that, although it is not easy to detect the practices of (legal) manipulation of results, it is always possible to detect the existence of fraud or illegal practices. This verification by the auditor is, therefore, an inhibitor of such practices, although Mahami and Mouloudj (2020) consider that the auditor independence is necessary, but not sufficient to detect manipulation in financial statements.

5. Conclusions

The applicability of NCRF 4 and IAS 8, allow the financial statements to transmit to stakeholders, a comparable, consistent, real, and reliable picture of the reality of companies, since it requires the disclosure of all materially relevant changes (Carvalho, 2012).

To improve the reliability and relevance of financial statements, as well as maintain the comparability of financial information, a correct application of NCFR 4 and IAS 8 is very important.

To assess the relevance that auditors (non-ROC) and statutory auditors (ROC) attribute to the application of accounting policies, to the changes in estimates and errors and their relationship with the improvement of the quality of financial reporting and the prevention of result manipulation practices, four professionals were interviewed.

It is concluded that the auditor plays an important role in applying judgement in the application of accounting policies, in validating the use of accounting estimates and their changes and in detecting errors. They consider that this role can be a deterrent to profit manipulation practices. They also consider that ethics, professional scepticism, and the degree of independence of the auditor contribute towards an improvement in the quality of financial reporting and a reduction in result manipulation practices.

The work of these professionals is guided by ethical principles, namely independence and professional scepticism, which are fundamental for the prevention of result manipulation, creative accounting, and fraud. In short, these professionals generally consider that their role is important in validating value judgements and dissuading the practice of result manipulation. However, the statutory auditors (ROC) expressed their opinions based on their professional experience, being more objective and pragmatic, while the auditors (non-SAs) expressed their opinions based on theory and less on practical reasoning.

This study seeks to contribute to the recognition of a greater relevance of both the application of judgements in the preparation of financial statements and the audit work in validating these judgements. These contributions may have practical applicability in the auditor's work through a more concrete expression, increasing transparency and reliability in financial statements.

Throughout this study, some limitations were encountered. The most relevant were the small sample size (only four respondents). Also, the limitation inherent to the adopted methodology, namely the difficulty in transcribing the interview, which may unintentionally change the meaning that the interviewee wanted to give or not reveal all its meaning.

Further studies on the application of value judgements and their validation are considered fundamental as future research proposals. Studies on the prevention of result manipulation and improvement of financial reporting are also very relevant, given the evolution of accounting and related sciences.

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