Increasing Importance of Independent Audit of Financial Statements in Developing Countries

Hilmi KIRLIOĞLU
Prof. Dr., Sakarya University
Turkey
hilmik@sakarya.edu.tr

Ali AKAYTAY
Lect., Duzce University
Turkey
aliakaytay@duzce.edu.tr

Abstract: In an economy, basic function of money and capital markets are to ensure the converting savings into investment. Unlike the money markets in the capital markets investors individually may choose the investment tool directly which they want to buy. It has great importance for a country's economy that investors to convert their savings effectively into investment. This is possible only if the reliable and timely information need of investors are provided. In this respect, the importance of the subject of accurate and reliable financial information of financial statements announced to public periodically that effect directly the price of investment tools in the capital markets is increasing day to day. Today accurateness and reliability of announced financial informations are seriously examined by users of informations that are announced by companies like shareholders, investors, lenders, consulting organisations and public. First the question "which factors effect the reliability and accurateness of announced financial informations" will be discussed in this paper. And the increasing importance of independent auditing will be emphasized. Besides, in today's economical conditions, the factors that are complicating the role of independent auditor and possible technological tools that can be used to increase the efficiency of auditing by eliminating these factors will be addressed.

Introduction

Some recent events and developments in business and especially in auditing environment which will be discussed below, have highlighted some problems in the auditing process. As a result of these events, it can be seen clearly now that auditors need to take the necessary steps to restore the public confidence in developing and developed capital markets. It's clearly understood that various arrangments must be done about the auditing process.

Events in the begining of 2000's start with Enron – Arthur/Anderson and continue with the others reduced investors confidence to financial statement that are passed from independent auditing. Enron's stock price, which hit a high of US$90 per share in mid-2000, caused shareholders to lose nearly $11 billion when it plummeted to less than $1 by the end of November 2001. The U.S. Securities and Exchange Commission (SEC) began an investigation, and Dynegy offered to purchase the company at a fire sale price. When the deal fell through, Enron filed for bankruptcy on December 2, 2001 under Chapter 11 of the United States Bankruptcy Code, and with assets of $63.4 billion, it was the largest corporate bankruptcy in U.S. history until WorldCom's 2002 bankruptcy (Benston, 2009:497). The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron undoubtedly is the biggest audit failure (Bratton, 2002:61). Even, for Krugman (Krugmen, 2002) the most important event lived in recent years that made critical changes in American society was not September 11, it was the event of Enron.

On July 21, 2002, WorldCom filed for Chapter 11 bankruptcy protection in the largest such filing in United States history at the time (since overtaken by the collapse of Lehman Brothers and Washington Mutual in September 2008). WorldCom changed its name to MCI, and moved its corporate headquarters from Clinton, Mississippi, to Dulles, Virginia, on April 14, 2003. Under the bankruptcy reorganization agreement, the company paid $750

million to the SEC in cash and stock in the new MCI, which was intended to be paid to wronged investors (SEC report, 2009)

A well known fact is that too many companies have problems with their bookkeeping. Siebel Systems, Qwest and Xerox are examples of companies that have been “cooking the books”. We can call the year 2002 “the horrible year” from a bookkeeping point of view. Unfortunately the year 2002 was not an exception. This manipulation is still going on. A fairly recent example is the Dutch retail trade company Royal Ahold, whose subsidiary in the USA manipulated the operating profit. There are also examples from earlier years. Two of them com from the banking world, where the UK Baring’s Bank and the Japanese Daiwa’s Bank lost millions of dollars because of they did not have effective control systems. The third one is a Finnish multinational company, whose subsidiary in Italy overestimated the work in progress and recorded fictious sales. Although the above examples are the tip of the iceberg, they reflect the changing nature and demands in the audit process (Koskivara, 2004:192). In this point the importance of control of business operations and independent auditing can be seen clearly. In the next title concept of accounting manipulation will be discussed.

Concept of Accounting Manipulation

In the literature and practice several concepts are used in the context of manipulation of financial statements. These concepts are quite similar to each other in some publications to be used interchangeably although there are some differences between them. In this context, the following concepts are to the fore in the literature:

- Earnings management
- Income Smoothing
- Big Bath Accounting
- Aggressive Accounting
- Fraudulent Financial Reporting

Each of these concepts have similar consequences and main purpose as to give a different impression to financial information users and affecting their decisions are taken into consideration. Before diving into what earnings management is, it is important to have a solid understanding of what we mean when we refer to earnings. Earnings are the profits of a company. Investors and analysts look to earnings to determine the attractiveness of a particular stock. Companies with poor earnings prospects will typically have lower share prices than those with good prospects. Remember that a company's ability to generate profit in the future plays a very important role in determining a stock's price. That said, earnings management is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target. This practice is carried out for the purpose of income smoothing. Thus, rather than having years of exceptionally good or bad earnings, companies will try to keep the figures relatively stable by adding and removing cash from reserve accounts (known colloquially as "cookie jar" accounts) (Investopedia, 2010). The term ‘earnings management’ embodies a wide array of accounting techniques used by management to manipulate the earnings of an entity. While there exists no single accepted definition of earnings management, the accounting literature provides various descriptions of the practice. Schipper (1989:92) describes earnings management as “ . . . a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain . . .”. Similarly, Healy and Wahlen (1999: 368) explain that earnings management occurs when managers use discretion to manipulate financial information “ . . . to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.” Consistent among these definitions is the notion of intentional manipulation of reported numbers by management. However, since managerial intent is unobservable, the current definitions of earnings management are “ . . . difficult to operationalise directly using attributes of reported accounting numbers . . . ” (Dechow and Skinner, 2000:238; Powell et al., 2005:9).

One of the hardest accounting frauds to spot is big bath accounting. When a company is doing really bad and has no chance of meeting earning expectations, unscrupulous management would begin writing-off every expense and asset they could imagine. As a result, future expenses are reduced significantly and naturallyearnings increase. In other words, the company is taking a big bath in the worst year so it can wipe its slate clean. This almost always guarantees record-breaking earnings in subsequent years, likewise performance bonuses (Yuan, 2008). Numerous definitions of the term ‘fraud’ have been proposed within the academic and professional literatures. In the criminological, and most general, sense, fraud refers to “ . . . any crime for gain which uses deception as its principal modus operandi” (Wells 1997: 4). Fraud encompasses a range of deceptions including

employee fraud, payroll fraud, insurance fraud, credit card fraud, identity theft, bribery, kickbacks, insider trading, and the deliberate falsification of financial reports. Financial reporting fraud involves intentional deceit on behalf of the preparers of the financial reports, and attempted concealment of that deceit (Albrecht 2003; Albrecht and Albrecht 2004). Such actions result in the financial reports not representing a true and fair view of the company's underlying economic position. Fraudulent accounting can be perpetrated in a variety of ways including improper revenue and expense recognition, fictitious revenues and assets, over and/or undervalued assets and liabilities, improper disclosures, and related party transactions (Powell et al., 2005:6).

Incentives of Accounting Manipulation

Preparing and disclosure of reliable financial statements are in the responsibility of company managers. As a whole, even the company management may work to fulfill its responsibility but some reasons may require financial information users questionize the financial statements that they use in their decisions.

Each day growing size of businesses caused increasing financial operations and workload of accounting departmants. Intense workload in the accounting departments, increase the likelihood of erroneous action, such as the increase in the number of employees also increases the likelihood of fraudulent transactions.

Financial information produced by companies to be approached with suspicion to justify a reason other users of information are largely outside of business. Users of financial information outside the business can get from the source itself is very difficult or even impossible.

Operating results of companies are prepared and disclosed by company managements. This situation also makes risky the reliability and accuracy of produced information. Because the accuracy and reliability of produced information are based on the behaviours of managers and its always possible to give fault information intentionally or unintentionally.

As a result of research covering 1982-1992 in United States done by Dechow, Sloan and Skinner (1996) gives the common characteristics of companies that made accounting manipulation are listed as follows:

- The majority of board members, are also consists of the general manager and other senior managers of the company,
- The majority of the general managers are also the founder of the company,
- The majority of companies don't have a partner that have a significant share and also is outside the management,
- The majority of companies don't have independent audit committee.

As a result of management structure to focus on specific individuals in this way causes in corporate governance issues, to be opened to manipulation and abuses depending on the intentions of the authorities. Also according to some researchs (Beattie, 1994; Carlson and Bathala, 1997) its understood that for their benefits company managers may apply to manipulation on financial information.

As a natural result of accrual basis accounting, managers have to decide on time and amount of accrue of income and expenses. This situation when combined with various policies and objectives inevitably leads to manipulation of financial information. In other words, accrual accounting and the flexibility that it gives to managers is one of the main reasons for the manipulation of financial information.

Companies that fail to reach analysts' estimates for multiple quarters can see their stocks drop precipitously. When Procter & Gamble warned that it would not meet analysts' consensus forecast in the first quarter of 2000, its stock price fell 30%. When P&G issued further warnings just before the end of the second quarter of 2000, the stock price fell another 10% and P&G's CFO was fired. As reported in CFO Magazine (December 1998), one CFO told SEC Chief Accountant Lynn Turner that when the CFO warned an analyst that the company might just miss consensus estimates, the analyst told him, "You're a bright guy; you'll figure out how to make it." Many companies depend on financial leverage in optimizing returns to stakeholders. To establish a business's creditworthiness, debt rating agencies use much of the same information as stock analysts. A slight drop in earnings or negative expectations about future prospects could cause a decline in a company's debt rating, increasing its cost of capital and diminishing prospects for new debt issues. Companies in highly competitive industries may want to maintain an edge in revenues or market share. In 1998, Sensormatic Electronics, a maker of security systems, actually stopped its clocks, which stamped shipping dates and times on finished products, 15 minutes before noon on the last day of a quarter, so it could continue to make customer shipments within the quarter until it had reached its sales target. The SEC brought charges and Sensormatic settled without admitting or denying misconduct. Many debt and lease agreements, as well as other contractual arrangements, contain covenants in which a company agrees to attain certain

earnings, debt, or other ratios, or limit payments to shareholders. When a company is in danger of missing one of the covenants, the agreement may provide for immediate repayment or other specified performance. Manipulating earnings slightly can improve ratios enough to avert such dangers (Duncan, 2001). Because of the reasons listed-above, it is unavoidable that independent auditors have to examine and tell his opinions about financial statements prepared by business managements that are going to be disclosed to public.

Effects of Independent Auditing for More Trusted Financial Statements

Because of the reasons listed above it is hard for investor to accept the reliability of financial information easily that they base upon their decisions. It is needed to be decreased the risk of being unreliable of financial information and some potential precautions can be thought for that.

One precaution maybe financial information users to audit the information they use their own. Reliability of the information coming out of business before it is used to examine whether the need is clear. One way to do this from the users of financial information are to control themselves. However, this application is often impossible because of information users usually not to know the control procedures, lack of time.

Sharing the risk of unreliable risk of financial information maybe thought as another precaution. Despite this logical path, and the legal implementation of the management of compensation seems to be a difficult process (Bozkurt, 1999:20). In accounting and auditing, internal control is defined as a process effected by an organization's structure, work and authority flows, people and management information systems, designed to help the organization accomplish specific goals or objectives. It is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in preventing and detecting fraud and protecting the organization's resources, both physical (e.g., machinery and property) and intangible (e.g., reputation or intellectual property such as trademarks).

In spite of the size of publicly traded companies are required to establish internal auditing system in their structure. In this sense, theoritically, internal control systems can be seen as a tool for public offering of the financial statements as accurate and reliable. However, according to Young (2002:18), in examined accounting manipulation events it’s seen that internal control systems can’t do the expected mission to offer financial information users to have exact reliable financial information.

The inadequacy of the precautions discussed above, requires an independent audit. In other words it seems as the most effective method in the time and cost issue that an independent person that’s confidential for all parties of information users will going to audit if the information prepared and disclosed by company management is reliable and accurate. Main task of independent auditor is to form a reasonable opinion about the financial statements of company for information users will basis their decisions confidentally. Independent auditors are under a big responsibility because of that his opinion affects all investment decisions of investors, in other words financial information users. Reliable information independently audited, will be guided in the right way in their decisions to all parties related to financial information of companies.

Conclusions

As a result of several recent developments in capital markets and the business world, financial information users need of accurate and reliable financial information is increasing every each passing day. To meet these needs and capital markets to work properly, is only possible with effective independent auditing.

While independent audit function undertake such an important role like this, for some reasons like the companies and transactions they operate are growing each day, it is not easy for independent auditor to achive his aim with classical auditing methods. It’s clear that auditor will need new tools for more effective auditing in today’s business world. For that academicians and practitioners have to give more attention on this subject.

As a result of information technology, computer operations capabilities of the software programming and particularly with the rapid developments in the increasing usage of these technologies to be adopted by businesses recording and reporting business transactions become more easier when compared with past. According to this we can say that its not easy even impossible auditors to audit their clients with classical manual methods and it’s clear that they must use these new technological tools for more effective audits.

In recent years another useful tool that academicians and practitioners work on for more effective audits is analytical review based on artificial neural networks. Several systems based on artificial neural networks and in widespread commercial use for accounting and financial tasks are described by Brown et al. (1995). These include:

- FALCON, used by six of the ten largest credit card companies to screen transactions for potential fraud.

- Inspector, used by Chemical Bank to screen foreign currency transactions.
- Several ANNs used to assist in managing investments by making predictions about debt and equity securities as well as derivative instruments.
- Several ANNs used for credit granting, including GMAC's Credit Advisor that grants instant credit for automobile loans.
- AREAS, used for residential property valuation. Developers of commercially used ANNs generally consider the inner workings of their systems to be proprietary information that gives them a competitive advantage.

As a result, artificial neural networks can be applied as a means of enhancing the effectiveness of independent audits and it can be said that its possible to have more successfull results when compared to traditional methods. We hope that our study draws attention to this important issue and will guide future research and applications.

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