Professional reasoning in expressing the auditor's opinion

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Abstract

Unlike other information, assertions and conclusions made during the audit process, the auditor's opinion expressed in the report on the accuracy of the financial statements in terms of the company’s image is available to all users. The result of a series of professional judgments based on complex theoretical and practical knowledge developed within the referential framework generated by the accounting and audit standards in order to detect misstatements, typological classifications and their correction, the opinion expressed by the auditor may have significant consequences. An inadequate opinion may alter the image of the entity in relation with all stakeholders, with serious implications on the continuity of the business. To the other extreme, an inadequate opinion may encourage unsustainable actions, with severe consequences both on own activity and on third parties.

Keywords: professional reasoning, opinion, significance, distorting

1. Introduction

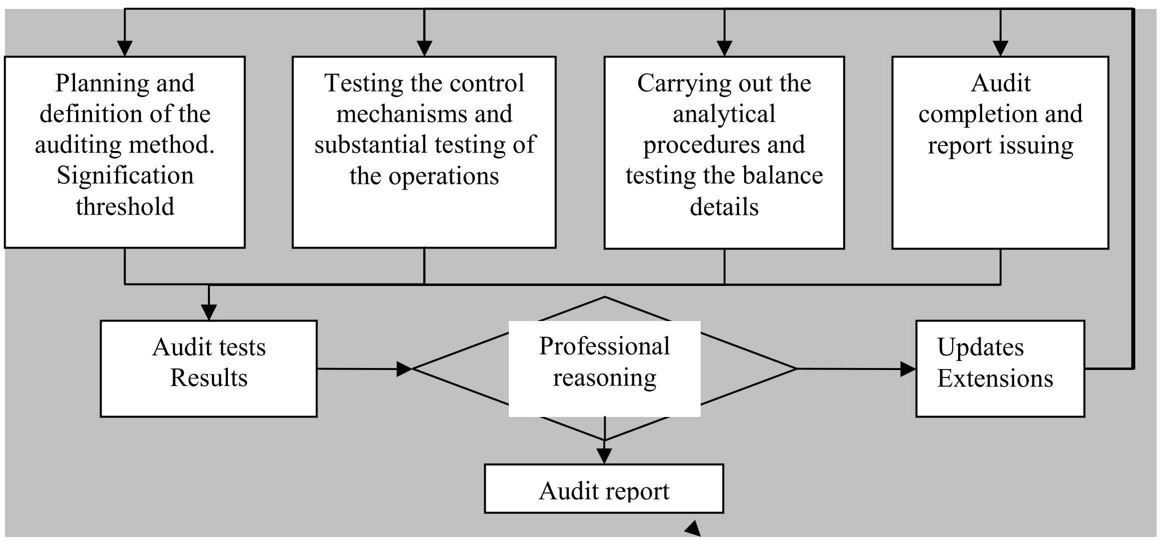
Expressing an opinion regarding the accurate presentation in all material respects, of the financial position, of the operating results and of the cash flows in accordance with an applicable financial reporting framework, based on justifying and adequate information, associates the auditor’s name with the audited financial statements - even if they are the responsibility of the management of the entity they are produced for - a guarantee for all potential users.

Attaining the objective of the financial statements' auditing is subject to professional reasoning. The reasoning is a chain of arguments used to assess a problem, a logical concatenation of judgments based on knowledge and concepts, leading to a conclusion. Professionalism in auditing lies in a complex of theoretical knowledge acquired through economic training in the strict enforcement of the International Financial Reporting Standards and International Auditing Standards, and the accumulation of experience in this field which is likely to enhance understanding and the ability to detect any differences.

At each stage of the auditing process, professional reasoning enables the assessment of the assertions of the audited company's management and of own previously-issued assertions their revaluation in case of detecting some arguments which invalidate or correct them, based on reiterations or expansion of the substantial tests and of the analytical procedures.

2. Professional reasoning

Professional reasoning based on a professional skepticism attitude is deemed to ensure reasonable assurance regarding the detecting of significant errors in the financial statements and their classification into categories.



Professional reasoning conditions the whole auditing process in all its phases[1] being ineluctably necessary in:

1. setting the possibilities of significant errors, taking into account:

   a. activity's characteristics (economic and legal environment of the activity);
   b. operating activity characteristics (type, complexity, anomalies etc.);
   c. company's financial stability (instability of financial resources, difficulties in financing the development or the working capital etc.)
   d. stringency of the control system and the company's interference in its carrying and in the preparation of the financial statements;

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[1] Arens Loebbecke – Audit, o abordare integrală –ARC Publishing House, Bucharest, 2003, page 437

e. linking the management's assertions with the audit objectives;
f. delimitation of the auditor’s responsibility from the management’s;

2. establishing the procedures for obtaining reasonable assurance that there are no significant errors:

a. significance threshold;
b. audit risk, its components (inherent risk, control risk, non-detection risk), overall and by section;
c. sampling and selecting items;
d. tests and analytical procedures on operations and balances;

3. classification of distortions detected in errors, illegal acts or fraud;

4. correlation, aggregation of errors and assessment of the on the financial statements and continuity of the activity;

5. expression of opinion based on the detected distortions and the management’s position regarding the correction of the financial statements.

The qualitative characteristics of the financial statements require that data and information contained in the documents reflect accurately, precisely, clearly and fully all economic and financial operations carried out or which will influence the performance and the position of the economic entities. Any deviation from this principle creates distortions in the financial statements.

Te complexity of the activities induce an inherent gap between the information held by the management of the audited entities and the information obtained by the auditor regarding the operations, assets, liabilities and equity. Given the information asymmetry, during an audit, professional reasoning is crucial in achieving reasonable assurance (not absolute) of the auditor that the financial statements do not have significant errors.

In the auditor's opinion, the maximum amount of error that the financial statements may contain without affecting the users' decisions is the threshold of significance, important reference in the reasoning of planning the appropriate evidence to be collected. The general framework sets forth that for the preparation and presentation of the financial statements, information is significant if its omission or erroneous declaration may influence the economic decisions of its users[2]

The significance threshold is:

- a reference against which it is determined whether errors, omissions, each one individually and all of them as a whole, cumulatively or aggregately, are likely to

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[2] Accounting regulations according to IV Directive of the EEC, approved by OMFP 1752/2005

alter the fair, accurate and complete image on the position and performance of the audited entity;

- a size correlated with the users' needs, the characteristics of the audited entity (activity scope, entity's size, development in time, sensitive changes), characteristics of the elements considered to be significant factors (sensitivity, degree of approximation, evolution of the element and the verification of possible fraudulent distortions, aggregation of several errors which may cause significant deviations from the accurate image);
- dynamic size, modifiable as the audit progresses, according to several variables: legal, statutory, contractual provisions; annual evolution of the elements; anomalies;
- a size inversely proportional to audit risk and proportionate to the costs involved by verifications.

Therefore the significance threshold offers rather a limit than a primary qualitative characteristic of the information to be useful[3] and from which the effect of errors may influence the users' decision.

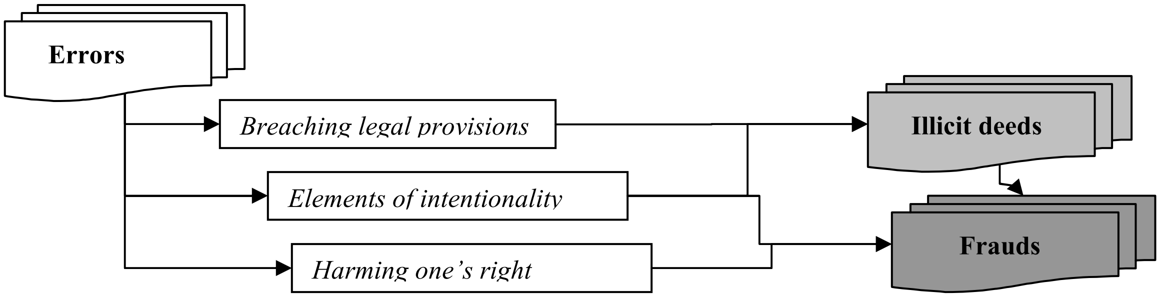
3. Errors and frauds

Distortions in the financial statements may be generated by errors and frauds.

Errors are false, unintended information determined by the disparity between our perceptions and reality confirmed by practice, which is the difference between the actual value of a size and the calculated value, deviations from an identified general framework of financial reporting framework.

Errors may mainly come from:

- mathematical and accounting errors,
- omission of facts, documents, legal provisions,
- false representation of facts,
- incorrect interpretation of laws, accounting policies or provisions.



[3] ISA 320 – Significance threshold in audit

Given these assertions, any significant errors discovered during an audit, even if not intentional but may harm a user's the interests, while creating an advantage to the defaulting, may be interpreted as a fraud, and if it is only a deviation from the legal norms, as an illicit deed. The elements of intent are often difficult to prove, requiring additional legal expertise and significant expenditure which would impede the audit process under the best relation between the reasonable assurance that there are no significant errors and the induced costs. Based on the professional reasoning, the auditor shall determine in the planning stage the areas where significant errors may occur and the likelihood of infringements and frauds in the context of general information, the company's position, and the interests of management. The control mechanisms testing phase enables the highlighting of the possibility of realizing the potential distortion.

Infringements are defined as violations of laws or regulations set by the authorities others than fraudulent acts[4]. Infringements can have direct impact on accounts such as those relating to the calculation of income tax, or indirectly, their effect is shown in the accounts only as fines and penalties, such as certain infringements of certain merchandise transportation regime, rules environment infringement, etc. The auditing standards establish explicitly that the auditor does not provide any assurance regarding the detection of infringements, requiring more extensive legal knowledge. In this area, in order to obtain reasonable assurance requires the examination of the governing bodies and the questioning of the legal advisors regarding the litigations. In case of detecting some illegal acts, the professional reasoning focuses on assessing the impact on their consequences on the financial statements but also on activity in general. Unlawful acts are usually known by the management and unless it has informed the auditor thereto, their relations could significantly alter. Some facts may have serious consequences on the future business that the auditor may have some comments on its continuity or may modify his/her opinion. Decisions relating to infringements with major implications are very complex and it is advisable to inform the due authorities thereto, particularly for the entities listed on the capital market.

Frauds are omissions, incorrect presentations, unlawful, deliberate, intentional acts, by which those who commit them obtain a material advantage by touching someone else's rights. In terms of auditing it is important to delimit frauds consisting of misappropriation of assets (usually acquiring some amounts or property by the employees) and fraudulent financial reporting involving the management. From this perspective, the acquiring of money by shareholders in various forms (advances to settlement/credit), even on the account of certain but non-distributed profits as dividends, is an illegal behavior, the difference in approach altering the relationship between the shareholder and the auditor.

The most frequent fraudulent reports are when the company's assets or turnover are overvalued or liabilities and expenses are understated, including the exercise independence failure.

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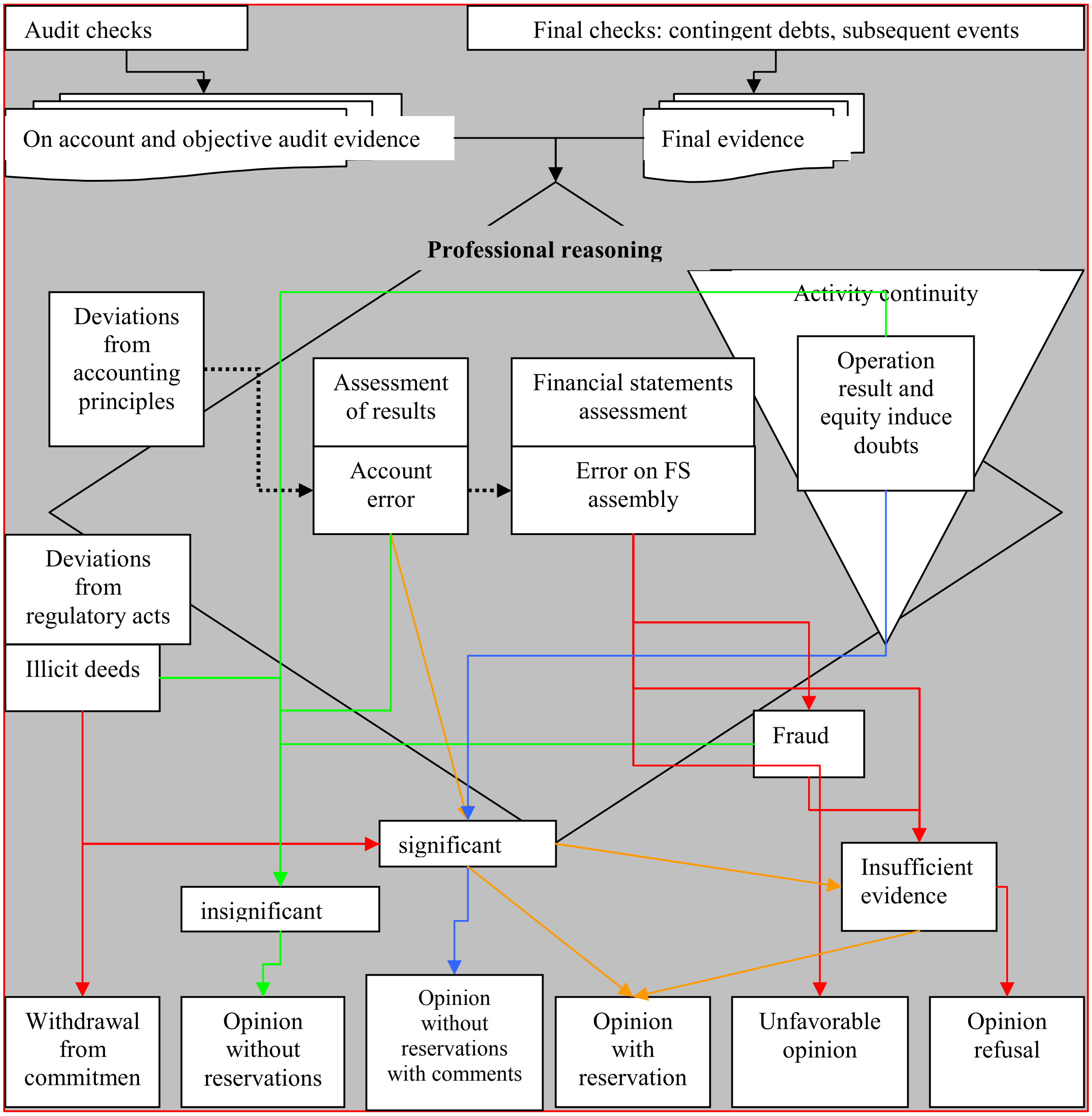
[4] Arens Loebbecke – Audit, o abordare integrală –ARC Publishing House, Bucharest, 2003, page 177

Frauds are more difficult to detect given the doers' dissimulations, which implies the envisaging with professional skepticism and rigor of the risk of error and fraud in the planning phase. The significant nature of errors and frauds is analyzed both for each item separately and for their combined effect. The significant level is considered the one that is likely to change the decision of the financial statements user's.

The summarizing of the adjustments proposed by the auditor on the balance sheet and on the profit and loss account may sometimes not be sufficient to signal significant deviations and distortions from the accurate image that the financial statements reflect.

The corroboration of the accounting and financial laws may induce incremental effects on the issues. For some time, the legal environment boosted the possibility of preparing some financial statements which did not represent the companies' accurate image. In this respect, we mention the allowed alternative treatments to calculate the assets' fair value, the permissive regulations for depreciation and pay roll (for the majority state-owned companies) which led to the decapitalization of the companies and distribution of undue dividends.

The aggregation of assertions and conclusions on each phase, cycle and account, within the final professional reasoning to issue an opinion on the financial statements requires an overall review of all relevant evidence including the final phase's:



The image above illustrates some of the many inter-conditioned types of distortions, framing within the significance threshold on account, implication on the overall financial statements, limited check perimeter either by circumstances (time, cost, status conditioning) or by the client, corrections impossibility (approved and even submitted financial statements) or refusal of corrections, infringements, errors, which aggregated imply a fraudulent conduct which are likely to influence the auditor's reasoning and impose a particular view.

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3. Order no. 1752 of November 17, 2005 for the approval of the accounting regulations consistent with the European directives, published in the Official Gazette under number 1080 dated November 30, 2005
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