THE INFLUENCE OF ACCOUNTANCY ERRORS ON FINANCIAL AND TAX REPORTS

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Abstract

To make mistakes is human. An accountant may do mistakes, too. Accountancy errors are defined and classsified by accounting regulations. These set what is the accountant treatment for correcting accountancy errors. However, even though one of the objectives in accounting normalization is made by the disconnection between accountancy and taxation, the accountancy errors influence especially tax reports.

We will further point the impact of accountancy errors on financial and tax reports. We will also approach the accountancy principles that impose the rules described for correcting the errors.

Keywords: *Accountancy errors, accountancy principles, financial reports, tax reports, reported result.*

1. Introduction

In every field of activity errors may occur. In carrying out the accounting activity, there may occur errors possibly referring mathematical mistakes, mistakes in applying accounting policies, ignoring or misapplication of the accounting judgment to the recognition of elements of financial statements, booking omissions.

In this study, we shall present the way the accounting errors affect the accounting and fiscal reports and the accounting principles applied to the specialist's reasoning to correct them.

In carrying out activity by the economic entities, there may occur situations in which some elements of the annual financial statements cannot be measured with precision, but only estimated.

Estimates can be easily confused with accounting errors because they sometimes require revision. The revision is not the correction of an error.

Unlike the correction of accounting errors, the estimates revision does not affect the tax reporting. They affect the financial statements.

Particularly important for the correction of the accounting errors is the date on which they are corrected and the financial year which they belong to. This information helps with determining the way to correct accounting errors.

An important issue addressed in the field is the error analysis so as to distinguish between errors and fraud. Our objective is to study accounting errors and, maybe in another work, we shall address the delicate issue of the border between error and fraud.

„The distinguishing feature between error and fraud would be the intentional nature of fraud. Error would result from a fortuitous action, not intentionally malicious and not with the purpose to distort the true financial performance of firms that disclose accounting information. An irregularity can be seen as an intentional act that does not, however, have the purpose of generating an illegal advantage[1].

This study can help managers and auditors to understand the common circumstances and types of errors, and thus what activities to monitor more closely. The study also contributes to the academic literature by comparing the errors to estimations, by examining the influence on financial and tax reporting.

Besides the theoretical approach of the way to correct accounting errors, a case study on the correction of accounting errors will complete the work. This may be helpful for the accounting practitioners, managers, auditors, but it may also be used as material in future research.

The topic is little discussed in the specific literature.

Since accounting is a standardized science, the main source of information for the present study were the provisions of the Accounting Regulations on the individual annual financial statements and the consolidated financial statements, approved through the Order 1802/2014 issued by the Minister of Public Finance.

The author of the article "Accounting Errors and Errors of Accounting"[2] highlights the importance of assuming the accounting errors: "Accounting should pay more attention to errors, as errors are essential for the updating of beliefs. Accounting is an information system, and errors are

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[1] Antonio Martins, Cristina Sa - Accounting errors, financial information and presumption based taxation: the Portuguese case – OBEGEF, Edicoes Humus, febr 2015, http://www.gestaodefraude.eu/wordpress/wp-content/uploads/2015/02/wp034.pdf

[2] John Christensen - Accounting Errors and Errors of Accounting – AAA Digital Lybrary, Volume 85, Issue 6, pp 1827 – 1838.

the carriers of information according to Bayes' Theorem. Accountants are primarily concerned with the mean (value), but the variance of accounting numbers is equally important."

Christensen argues that „error is intrinsic to accounting systems, as it is to all information systems that seek to represent synthetically and objectively a corporate environment that is truly complex and subjective". According to this author, accounting serves several purposes in the context of economic systems, with diverse and contradictory interests.

Conflict between users is common. Thus, errors arise out of this conflict.

2. Accounting errors

2.1. What are accounting errors

Lourenço and Sarmento (2008: 34-35) state that "error", in the context of accounting, will emerge from a random, unintentional or eliberate act caused by negligenceor ignorance.

Errors possibly arising in respect of the recognition, assessment, presentation or disclosure of the financial statements elements. They do not comply with the accounting rules if they contain material or immaterial errors, errors intentionally made to achieve a particular presentation of the financial position, of the performance or cash flows of an entity.

Errors found in accounting may refer either to the current financial year, or to previous financial years.

Errors in prior periods are omissions and misstatements in the financial statements of the entity for one or several prior periods, arising from the mistake of using or not using reliable information that [3]:

k) was available when the financial statements for those periods were authorized for issue;

l) could reasonably be obtained and taken into account in the preparation and presentation of those annual financial statements.

Errors that may appear in the activity of an accountant may be:

- Mathematical mistakes;
- Mistakes in applying accounting policies;
- Ignoring or misapplication of the accounting judgment to the recognition of financial statements elements;
- Booking omissions.

Of the mathematical mistakes, we mention the calculation errors, but the most frequent ones are the inversions of the place of two figures. The latter obes are the most difficult to detect.

Errors in the application of the accounting policies occur, most often, in the situation where accounting is outsourced. Companies whose object of activity is the "Accounting" have a large portfolio of business entities, and the possibility of confusion regarding the accounting policies is higher.

However, as a result of frequent changes of legislation and of the burdensome implementation of the legislative requirements, companies are willing to outsource their services of fiscal assistance and accounting (67%), payroll and human resources management (40%) and legal administration (17%), in order to focus on their basic activities – this is the demonstration of a study by TMF Group Romania, a present since 17 years on outsourcing services market in Romania. In terms of the third category of accounting errors, here we may think if it comes about errors or fraud. The accounting reasoning may be intentionally ignorant, which creates doubts on the honesty of the accountant concerned.

Errors of prior periods also include the misrepresentation of information in the annual financial statements.

Sometimes, errors may be insignificant. Insignificant errors are not likely to influence the financial and accounting information. It is considered that an error is significant if it could influence the users' economic decisions taken on the basis of annual financial statements.

To determine whether an error is significant or not, an analysis is performed within the contextual point, given the nature or the individual or aggregate value of the items.

2.2. Corection of accounting errors

According to accounting regulation on individual financial statements and consolidated financial statements[4] correction of accounting errors is performed at the date of finding.

The accounting treatment which corrects an accounting error is differentiated according to the financial year which an error belongs to. Thus:

- Accounting errors belonging to the current financial year are corrected in the profit and loss account.
- Significant errors related to previous financial years are corrected on account of the retained earnings (account 1174 "Retained earnings resulted from the correction of accounting errors").
- Insignificant errors related to previous financial years are also corrected on account of the retained earnings. However, according to the approved accounting policies, the insignificant errors may be corrected in the profit and loss account.

[3] OMFP 1802 / 2014 - accounting reglulation individual financial statements and consolidated financial statements.
[4] Aproved by OMFP 1802/2014.

In case the correction of an error requires booking cancellation, by the accounting policies, the entity will choose the method of cancellation:

- Red cancellation;
- Black cancellation.

The choice of the cancellation method also depends on the cancellation method used by the software in use.

To correct accounting errors related to prior financial years, there will not be changed the financial statements of those financial years, in order to observe the principle of intangibility of the opening balance sheet.

According to this principle, the opening balance sheet of a financial year shall fully comply with the closing balance sheet of the preceding financial year.

The booking, on account of the retained earnings, of the correction of the significant errors related to previous years, as well as the change of the accounting policies are not considered breach of the principle of intangibility.

***Example**: An entity approved the financial statements of the year N on 04/04/N + 1. On 05/15/N + 1 they found that, during the previous year, a building depreciation had not been booked. The error shall be corrected on the date on which it is found, on account of retained earnings (1174 = 281), the opening balance strictly observing the closing balance sheet of the previous financial year.*

2.3. Errors versus estimates

In carrying out economic entities' activity, there are situations in which some elements of the annual financial statements cannot be assessed with precision, but only estimated.

Examples of situations that require estimates:

- bad debts;
- obsolescence of inventory;
- economic life;
- amount of provisions constituted;
- expected pattern of consumption of future economic benefits embodied in depreciable assets etc.

Estimation involves judgments based on the latest credible information available at a time. In a situation where there are changes in the initial information or new information occurs, the estimate may require revision.

The revision is not the correction of an error but a result of inherent uncertainties characterizing the economic environment.

Therefore, an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or of a better experience.

The use of reasonable estimates is an important part of the preparation and presentation of the financial statements. The credibility and relevance of the information in the financial statements are affected by the accounting estimates adopted.

For accounting practices, it is important the distinction between the changes in accounting estimates and the changes in the accounting policies.

A change in the valuation bases, even if based on estimates, represents a change in the accounting policies and not in the estimates. When it is difficult to distinguish between a change in the accounting policy and a change in an accounting estimate, the change in the accounting estimate prevails.

The effect of change in an accounting estimate is prospectively recognized by including it in the result of:

- the period of the change, if it affects only that period (for example, adjustments for bad debts); or
- the period of the change occurs and of future periods, if the change affects them, too (for example, the useful life of the tangible assets).

Unlike the correction of accounting errors, the change of an estimate is never booked in the retained earnings, it is not recognized retroactively.

Example:

An economic entity acquires a machine worth Lei 500,000. The useful life is 10 years, and the company books its depreciation it by the linear method. Due to the change of the conditions of use, at the end of the 2-nd operating year, the company decides that depreciation will be booked along a period of 8 years, the remaining useful life being of 6 years.

<u>Year 1:</u>

- *machine purchase*:

213 = 404 Lei 500,000

- *annual depreciation booking, during the first operating year*:

681 = 281 Lei 50,000

Annual depreciation = Lei 500,000 / 10 years = Lei 50,000 / year.

<u>*Year 2:*</u>

- *the economic life will be changed, by accounting estimate*:

remained depreciation value = 500,000 − 50,000 = Lei 450,000

annual depreciation =Lei 450,000 / 7 years = Lei 64,285

The 7 years consist of: 6 years + the 2-nd year during which the estimate is done.

681 = 281 Lei 64,285

- *during the following years (year 3,4,5,6,7,8), the booking will be repeated* :

681 = 281 Lei 64,285

3. Detecting of accounting errors

As shown in the second part of this work, accounting errors correction is not a difficult activity. But how do we detect the accounting errors?

Sometimes, accounting errors are detected incidentally. But we cannot rely on chance.

The moment for detecting most accounting errors is that of the preparatory works for the financial statements drawing up.

In this respect, based on a provisional trial balance, they check:

- the consistency between the accounting and the operational records, between the synthetic and analytic accounting;
- whether all justifying documents have been properly booked;
- the legality and honesty of the booked data, which must give a clear and comprehensive description of the economic and financial operations carried out;
- the accounts balances, so as the assets accounts book a final debit balance, and the liabilities accounts book a final credit balance;
- the balances total in the management report should match the balance of the account 371 "Merchandise";
- whether the cash balance is equal to the balance of the account 531 "Cash";
- whether expenditures and income were delimited in time, etc.

As a result of these checks, the probability of detecting possible accounting errors is quite high.

Error non-detection risk is influenced by the size of the economic entity for an important role in identifying errors belongs to the audit action which is not mandatory for micro-entities.

However, even if the financial audit is performed, the control risk cannot be zero for the internal controls cannot provide complete safety on preventing or detecting errors.

The auditor will establish a level of control so as errors arising from inherent risk may be determined.

Accounting errors are part of the qualitative factors affecting the audit materiality. Of these factors, we mention:

1. During the stage of the determining of the preliminary value of materiality:

- significant errors from previous years
- possible fraud
- minor presentation errors possibly affecting certain contractual obligations
- minor presentation errors possibly affecting the trend of the profits trend.

2. During the stage of estimating the distortions and of comparing them with the preliminary value of materiality:

- errors hiding a change in the evolution of profits
- errors causing the change of the loss by profit and vice versa
- errors possibly causing a major positive or negative reaction of the market.

Following the audit, the auditor states whether, on the basis of the knowledge and understanding gained during the audit in relation to the entity and its environment, he/she has identified significant erroneous information given in the directors' report, by indicating the nature of such erroneous information.

4. Reflecting accounting errors in accounting and fiscal statements

The discovery of an error may result in several consequences. Everything depends on the type of error, on the financial year it belongs to.

In the lines below, we establish the way to proceed in case, following an error, the following situation occurs.

At the end of June, during the year N, an economic entity issued a bond loan worth Lei 500,000, with an interest rate of 5% per year. The interest is to be paid at the end of each bond year. According to the accrual principle, although the company owes the interest on late June of the year N + 1, during the month of December of the year N it should book the interest for the period 07/01/N – 12/31/ N.

The interest to be booked for six months = Lei 500,000 x 5% x ½ years = Lei 12,500

Some of the accounting errors occur as a result of erroneous data typing. Thus, the accountant typed by mistake Lei 15,200 instead of Lei 12,500

666 Interest-related expenditure	=	1681 Interest related to bond loans	15,200

At the end of June N + 1, the due date on the debt related to the bond loans interest, the accountant discovered the error, respectively the booking of an interest related to the bond loans accrued by Lei 2,700 (Lei 15,200 – Lei 12,500 = Lei 2,700). The error also led to the overstatement of the expenditure on the interest by Lei 2,700.

According to the accounting regulations on the individual annual financial statements and the annual consolidated financial statements, the accounting errors are corrected at the time of their detection. The error correction will be booked as follows:

1681 Interest related to bond loans	=	1174 Remained earnings resulted from the accounting errors correction	2,700

From a fiscal standpoint, the principle according to which the fiscal result is calculated based on the incomes and expenses booked in accordance with the accounting provisions in force, the operation of correcting the booking errors, eliminating the idea that they could have been made with intent, should influence the taxable profit for the fiscal year during which the operation is performed.

Thus, the tax on profit calculated for the year N was declared and paid to the State Budget less Lei 432 (Lei 2,700 x 16% = Lei 432).

Although in accountancy the errors correction does not involve the correction of the accounting statements, the same is not true for taxation. For the statement on the tax on profit (Statement 101), the accountant should:

- - prepare and submit the statement of amendment,
- - pay the difference in the tax on profit, undeclared following the accounting error, and
- - calculate and pay delay penalties for the tax unpaid on due time.

As it may be seen, the tax implications arising from the correction of the accounting errors are more complex for they may involve additional costs.

If the error affects an income, the company pays extra tax on profit. If the profit obtained is distributed as dividends to the shareholders or associates, for the overpaid amounts it should ask for refunding. And, in such a situation, there arises tax on dividends paid extra. It should also be restored the statement 100 by which the company declared the tax on dividends.

4. Conclusions

In this paper, we have tried to combine the accounting and fiscal treatment of the accounting errors correction with the theoretical and applicative presentation of the theme we have chosen.

The accounting error correction is grounded by the principle of the opening balance sheet intangibility and the principle of the methods consistency. The latter is the foundation of the accounting policies handbook by which an economic entity must define the materiality threshold for accounting errors correction, on the one hand, and choose the method for errors cancellation in accountancy: the "red" or "black" cancellation method, on the other hand.

Many of the operations we need to correct require higher attention in terms of the regulations at the time, given the instability of the accounting and fiscal systems in Romania.

Given the current regulations, the main conclusion we have reached is the fact that the influence of the errors on the fiscal reporting is significant in terms of the accountant's activity, but especially in terms of additional costs incurred by the company. It is about penalties arising from the failure to pay some taxes on due time, or from the payment of extra taxes, depending on the structure affected, namely on the expenses or incomes.

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