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Executive Summary

The Study of Audit Adjustments

and the Relationship between Characteristics of Financial Statement Preparers and Audit Adjustments

Research funded by
the Securities and Exchange Commission, Thailand

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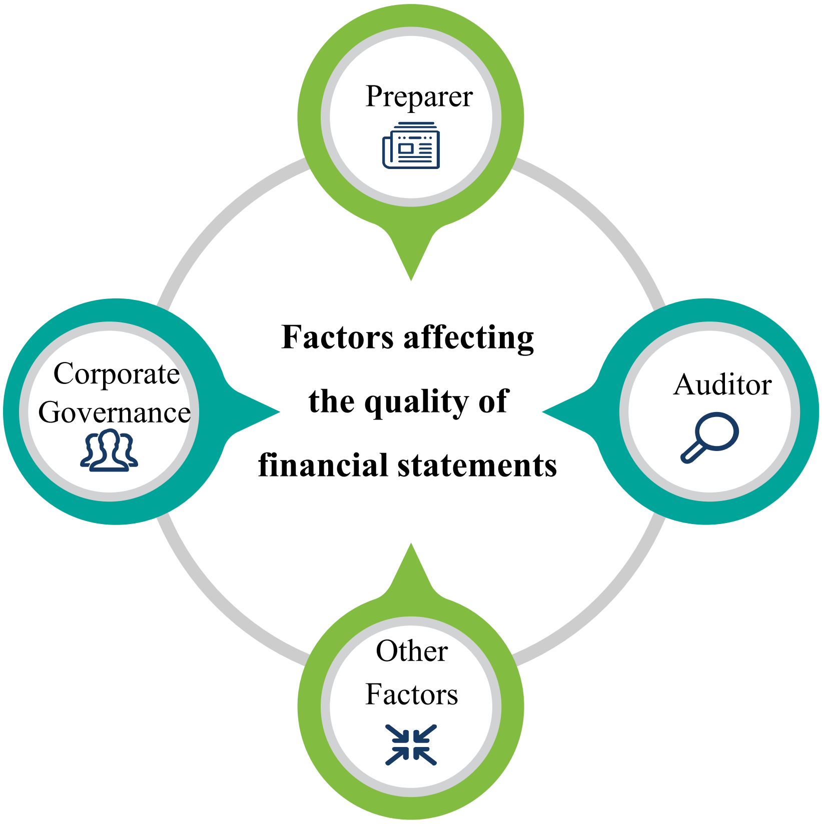
Introduction. There are many factors affecting *the quality of financial reporting* that issued to the financial statements users. The important factors include *the accounting department who prepares financial statements, auditors, the corporate governance of the entity that reports the financial statements*, and other factors.

Financial statements preparers control the initial quality of the financial statements before getting audited by auditors. If the financial statements are prepared correctly, auditors do not need to propose any adjustment. On the contrary, if the financial statements contain material misstatements, the auditor will ask the client to adjust the financial statements before issuing the final version to the financial statements users. Corporate governance affects the working environment of the whole company, including the financial reporting function. The audit committee, which is a part of corporate governance, communicates with auditors and executives to ensure the high quality of financial statements. Executives set tone at the top in a company, and are responsible for the accuracy of financial statements. Other factors such as changes in accounting standards may result in audit adjustments.



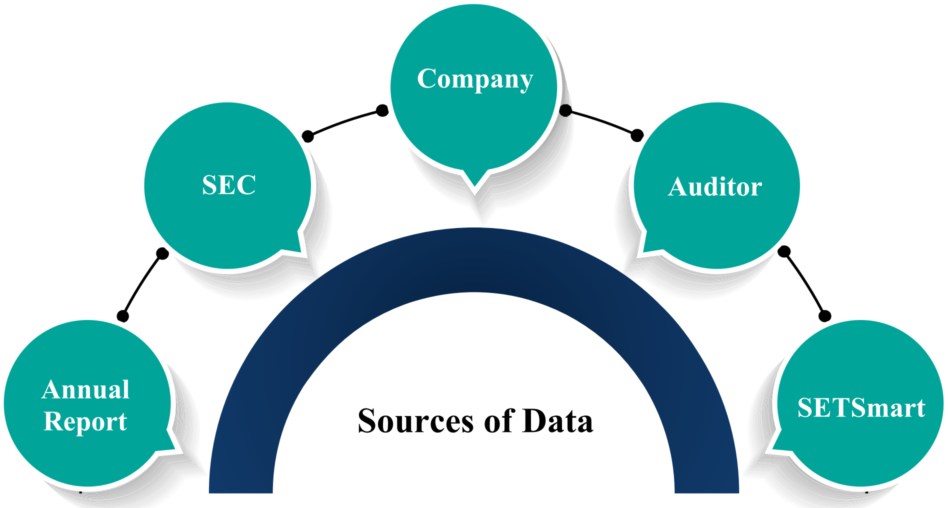
If the financial statements preparers prepare the correct financial statements since the beginning, the final version of financial statements would have high quality without relying on auditors to adjust the financial statements. The auditors may be able to reduce the audit time resulting in lower audit fees. The auditors can also put their effort into other areas of the company, which will allow them to provide suggestion to improve the operations of the company in those areas.

Objectives The previous studies on the quality of financial statements use the final version of financial statements after auditors adjust misstatements. Therefore, it is difficult to refer to the quality of the original financials statements prepared by the preparers. This study investigates the financial statements adjustments made by auditors and financial statements preparers after providing the trial balance to the auditors. Financial statements adjustments in this study include the adjustments proposed by financial statements preparers because these adjustments also indicate the quality of the first draft of financial statements that the auditors receive from the financial statements preparers.

There are 3 objectives in this study.

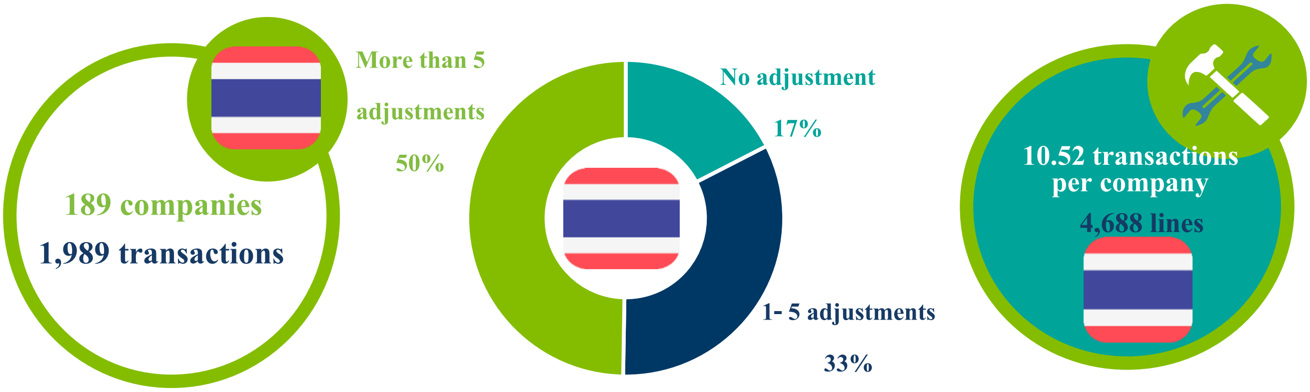
1. To investigate the *characteristics* of adjustments.
2. To investigate *factors* affecting adjustments.
3. To provide *suggestions* to improve the quality of financial reporting for Thai listed firms and regulators.

1. Characteristics **2. Factors** **3. Suggestions**

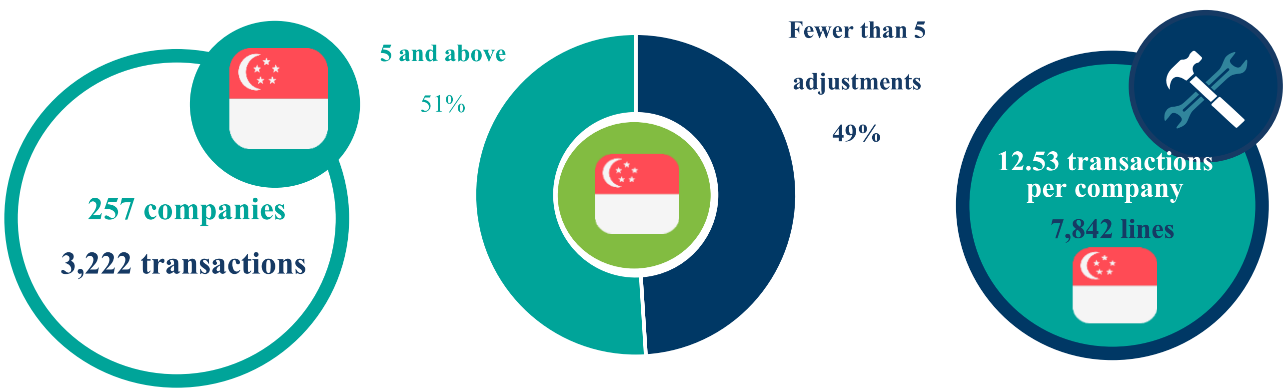


Sources of Data Information used in this study comes from 5 sources: listed companies in the SET and mai markets, auditors, SETSmart, annual report, and SEC. All participants join the project on voluntary basis. The participants send SEC consent letters allowing their auditors to disclose information to the research team. Then SEC or the research team forwards the letters to the auditors. The information that the participants provide includes information about directors, executives, and accounting department.

Auditors provide adjustments information. In order to analyze factors relating to the financial statements adjustments, there must be some controls variables. These control variables are financial numbers from SETSmart and other information such as audit fee comes from annual reports or other publicly available information on the company's website.



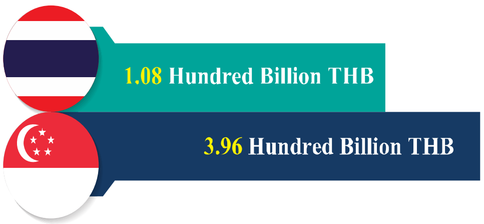
Adjustments Information There are *189 participants* in the project. The total number of adjustments is *1,989 transactions*. *33 companies (17%) report no financial statements adjustment.* 62 companies (33%) have 1 – 5 adjustments, and *94 companies (50%) report more than 5 adjustments*. The average adjustment number is *10.52* adjustments per company. Total number of adjustments lines is *4,688 lines*.



When compare to the previous study conducted in ***Singapore*** by Themin Suwardy, Jean Seow, and Lim Chu Yeong from Singapore Management University, their study has *257 participants*. The total number of adjustments is *3,222 transactions*. *49%* of the participants have *fewer than 5 adjustments*, and *51% have 5 or more adjustments*. The average adjustment number is *12.53 adjustments per company*. Total number of adjustments lines is *7,842 lines*.

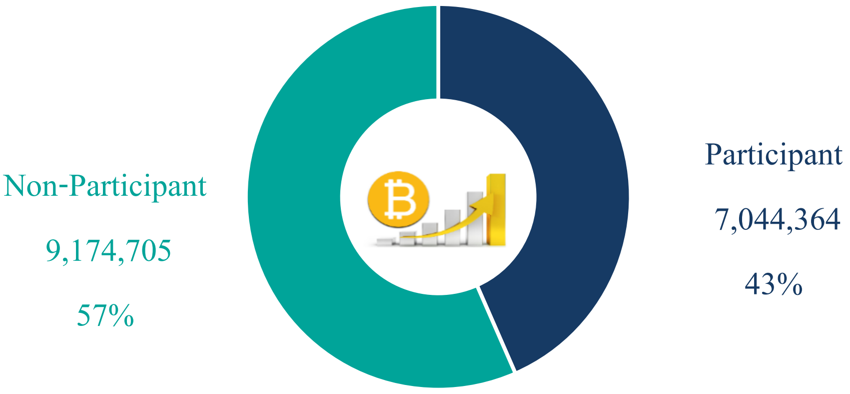
Although the average adjustments per company for this study is lower than that of Singapore study, it cannot be interpreted as Thailand financial reporting quality (measured at the original version of financial statements provided to auditors) is higher than that of Singapore companies. Although the participants of both projects are from voluntary basis, the companies in Thailand may still be concerned about joining this project knowing that SEC, the regulator of listed companies and audit firms, is the sponsor of this project. As a result, this study may face self selection bias. The participants are companies with lower adjustments than the non-participants. The non-participants may concern about the possible negative impact if they join the project and have to disclose the adjustment information.

In term of the numbers, total adjustment amount, without double counted debit and credit sides, is *1.08 hundred billion THB*. The amount for Singapore study without double counted debit and credit sides is *3.96 hundred billion THB*.

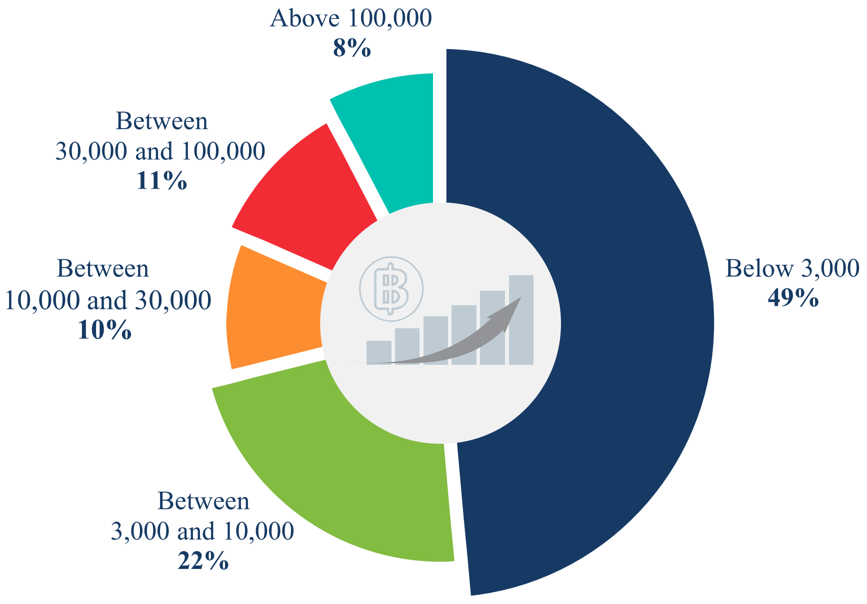


Market Capitalization of the participants as measured as of December 31st, 2018 is *7.04 trillion THB* or 43% of the SET and mai market capitalization.

Market Capitalization of Participants and Non-participants (Million THB)



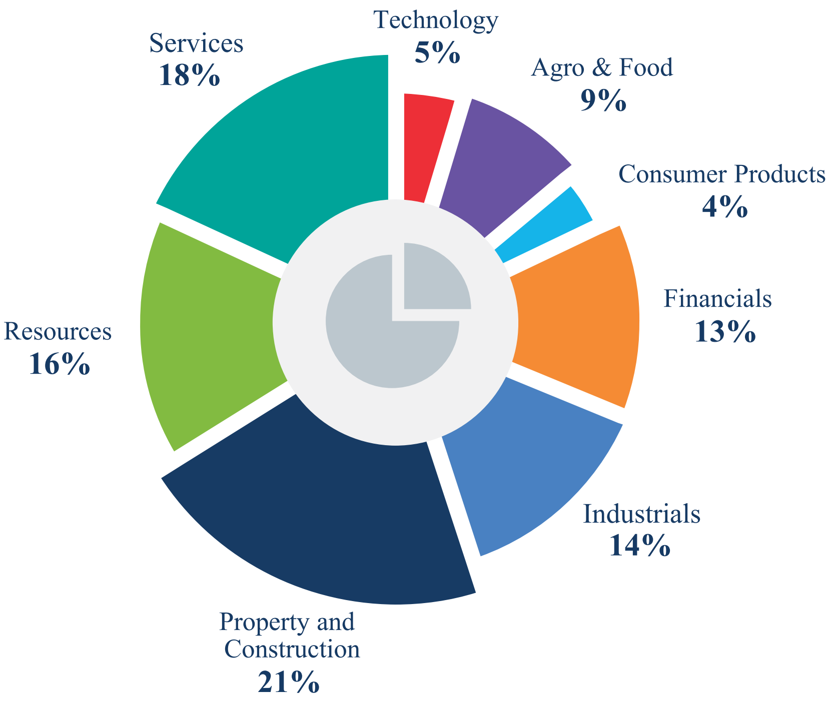
Market Capitalization of Participants (Million THB)



When consider the size of the participants by their market capitalization, ***nearly half of them (49%) are small size firms with market capitalization below 3,000 million THB*** and 22% of the participants are medium size firms with market capitalization between 3,000 – 10,000 million THB.

When categorize the participants into business industries, 21% of the participants are from Property and Construction. The other main industries include Services, Resources, Industrials, and Financials with 18%, 16%, 14%, and 13% of participants, respectively.

Participants by Industry



Financial Statements Adjustments Categorized by Detector, First time/Recurring, and Reclassify/ Adjustment

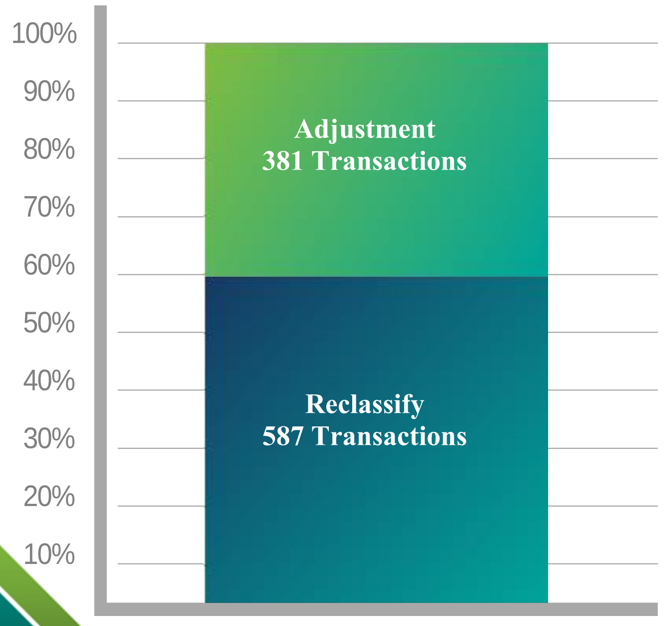
Detector	Transactions	Lines
Auditor	968	2,281
Client	1,021	2,407
First time/Recurring	**Transactions**	**Lines**
First time	883	2,108
Recurring	1,106	2,580
Reclassify/Adjustment	**Transactions**	**Lines**
Reclassify	903	2,024
Adjustment	1,086	2,664

From 1,989 adjustments, *more than half* (1,021 transactions) are proposed by the *financial statement preparers.* These adjustments should be detected and corrected before submitting the trial balance to the auditors. From the interview with auditors and financial statements preparers, the preparers are not certain about the adjustment numbers, so they wait to consult with the auditors. Some transactions are from accounting systems that do not allow modifications. The financial statements preparers cannot add new accounts into the system. They have to manually adjust the account balances after getting the trial balance from the system. However, these transactions should be adjusted before preparing the trial balance for the auditors. Another important reason for client detected adjustments is the lateness of receiving information and documents from other departments in the company. Due to a short time window to close the accounts and prepare the trial balance for the auditors, and lacks of communication with other departments, the accounting department cannot get all supporting documents on the closing day. When the documents arrive after the accounting department sends the auditor the trial balance, the accounting department needs to make adjustments.

From these reasons, *more than half of these adjustments (1,106 transactions) are recurring transactions*, which occur before in the previous periods. The financial statement preparers and governance body of the company should put priority in these issues and prevent them from reoccurring. If the adjustments are from the lateness of information from other departments on the closing date and during the preparation of the trial balance, the accounting department cannot fix them. The executives need to set *tone at the top* about the important of accounting function and *communicate to all departments* in the company to send supporting documents to the accounting department on time.

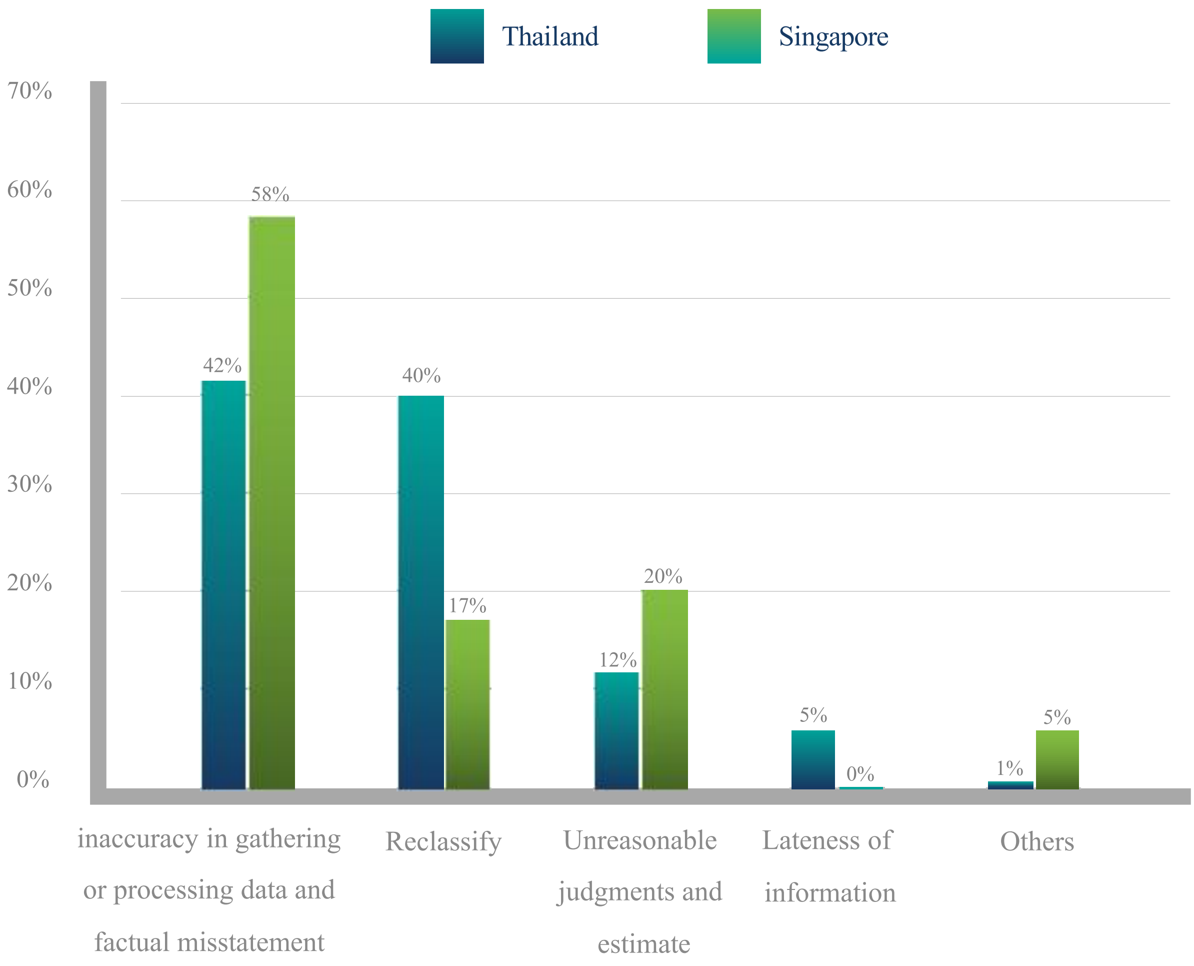
When categorizing the transactions into reclassify and adjustment transactions, which are transactions that have an impact on the net income, the reclassify and adjustment transactions are around half for each type. There are *903 reclassify transactions and 1,086 adjustment transactions*.

Adjustment VS. Reclassify by auditor



When consider only the auditor proposed transactions, reclassify is more than adjustment transactions. There are 587 auditor proposed reclassify transactions, and 381 auditor proposed adjustment transactions. The reclassify transactions may come from the accounting system that cannot add or separate accounts, while the adjustment transactions may come from the understanding of the financial reporting standards. Those in charge of accounting department and executives should emphasize on *continuing professional education* and encourage accounting staffs to attend *seminars* to acquire knowledge about accounting practices related to the company.

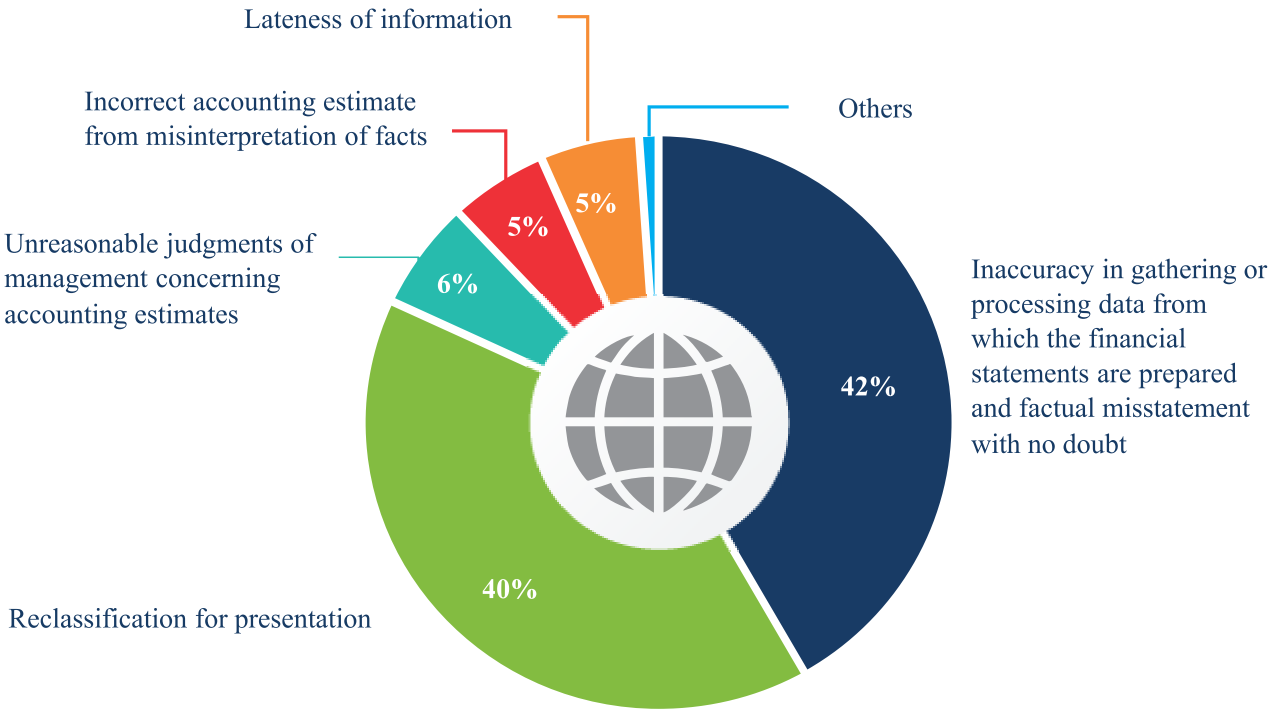
Reasons of Adjustments as Compare to Singapore



Auditors provide a reason for each adjustment transaction. The major reasons are *an inaccuracy in gathering or processing data* from which the financial statements are prepared and factual misstatement with no doubt *(42%),* and *reclassification* for presentation *(40%).* Incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts and unreasonable judgments of management concerning accounting estimates only account for 12%.

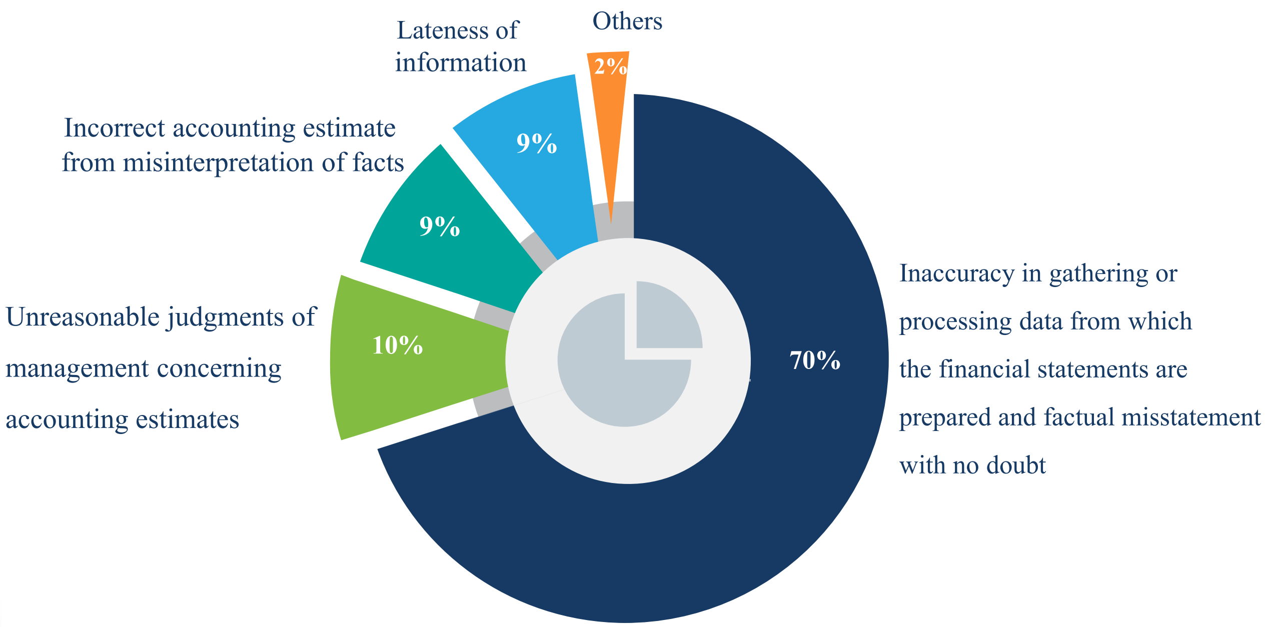
As comparing to Singapore study, the most adjustment reason is the same. However, the second most reason of Singapore study is about accounting estimate and judgments of management. In addition, auditors in this Thailand study indicate that 5% of the adjustments are from the lateness of information.

Main reason of Adjustments by Auditor



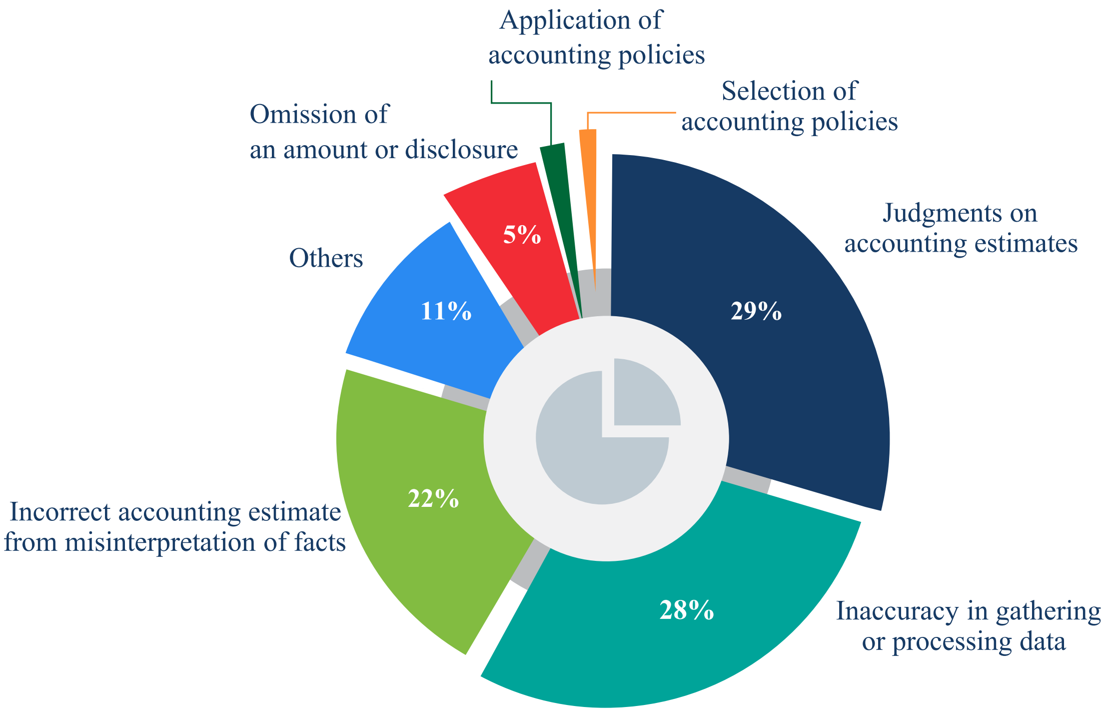
Auditors provide reasons for each adjustment. *42% of adjustments are due to an inaccuracy in gathering or processing data fro*m which the financial statements are prepared and factual misstatement with no doubt. Another 40% of an adjustments are reclassifications for presentation propose. The auditors inform that only 6% of the adjustments are due to unreasonable judgments of management concerning accounting estimates.

Main Reasons of Adjustments by Auditors (without reclassify)



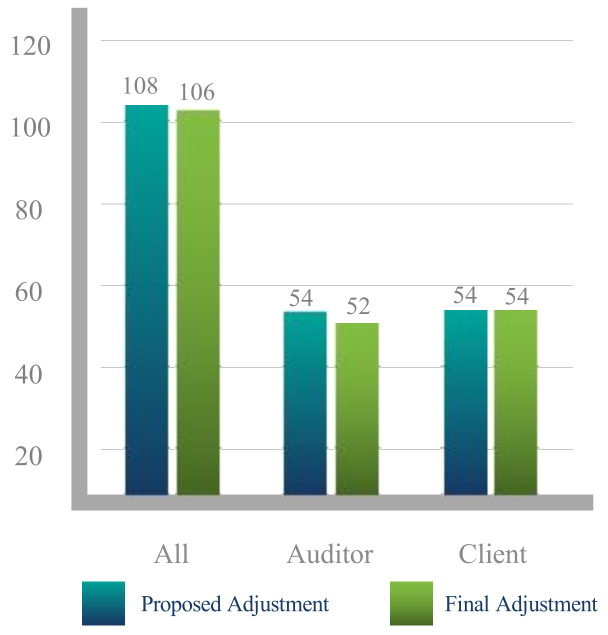
When analyze only adjustment transactions by removing reclassify transactions, the main reason of audit adjustments remains *an inaccuracy in gathering or processing data* from which the financial statements are prepared and factual misstatement with no doubt, which accounts for *70%* of all audit adjustments. Incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts and unreasonable judgments of management concerning accounting estimates only account for 19%. *Lateness of information* brings *9%* of audit adjustments.

Main Reasons of Adjustments by Financial Statement Preparers



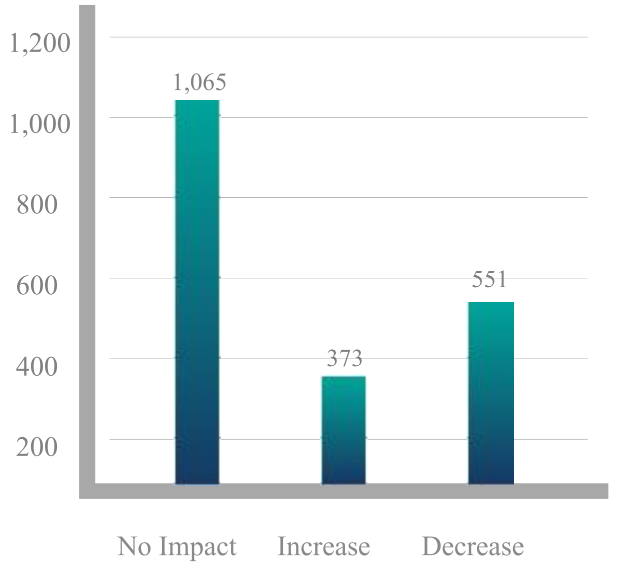
Financial statements preparers also provide opinion on the reasons of adjustments. They believe that *29%* of the adjustments are from *judgment about accounting estimates* and *22%* are from *incorrect accounting estimates from misinterpretation of facts*. Only 28% believe that an inaccuracy in gathering or processing data from which the financial statements are prepared and factual misstatement with no doubt is the reason of adjustments. The results indicate that the financial statements preparers may not fully aware of the real reason of adjustments. Financial statements preparers expect that 51% of adjustments relate to accounting estimates. However, auditors indicate that the major reason of adjustments is an inaccuracy in gathering or processing data from which the financial statements are prepared and factual misstatement with no doubt. Both parties should communicate more, and inform the management, on adjustment issues in order to prevent the same misstatements in the future.

Proposed and Final Adjustment Amount (Billion THB)



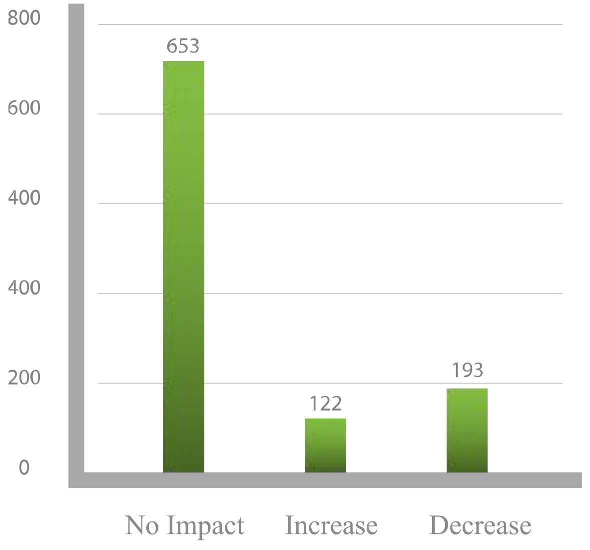
Comparing proposed and final adjustments, the amounts are quite similar. From 108 billion THB proposed adjustment amount, *106 billion THB is finally adjusted*. The proposed about by auditors is 54 billion THB and *final audit adjustment amount is 52 billion THB*. Client proposed and adjustment amounts are very similar at about 54 billion THB. The information provide a clear contribution of audit work. Without the auditors, the financial statements provided to financial statements users will contain 52 billion THB of misstatements. Another aspect that this result supports is that the financial statements preparers tend to adjust the financial statements upon auditors' request.

Total Adjustment and Net Income Impact (transactions)



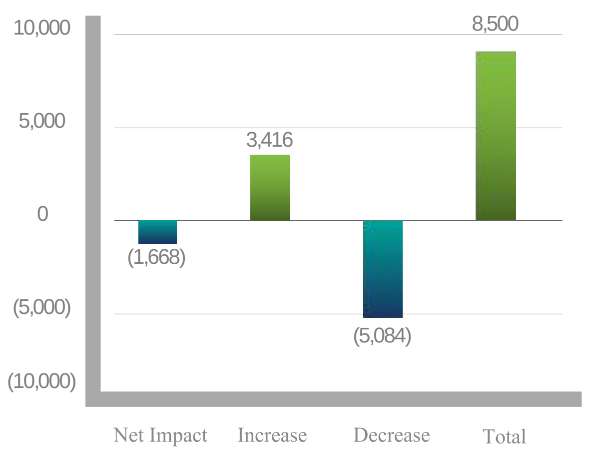
The results from categorizing the adjustment by net income impact support that most of adjustments by both auditors and financial statements preparers are reclassify transactions, which have no impact on net income. As a result, *1,065 transactions of adjustments* have *no impact on net income*. Some transactions are recorded with net amount of an asset and a liability. In preparing financial statements, gross amount should be reported rather than net amount. Some transactions are from lack of system support. Financial statements preparers must manually reclassify these transactions.

Auditor Adjustment and Net Income Impact (transactions)



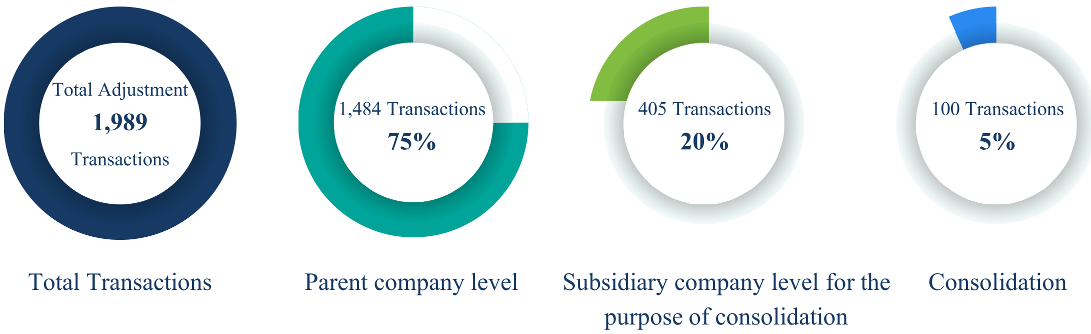
There are ***more*** adjustments to ***decrease*** the ***overstated net income (193 transactions)*** than adjustments to increase the understated net income (122 transactions). The results are consistent with the information from auditor interviews. The adjustments are from both expense and revenue sides. For the expense side, the lateness of information prevent the accounting department from properly accrue the expense. For the revenue side, some firms recognize revenue when invoices are issued, not at the point of sales or transferring goods to customers. The auditors must decrease the revenues that companies record before the revenue recognition point under the accounting standard.

Impact on Net Income (Million THB)



Total adjustments result in 1,668 million THB decrease in the net income, which can be separated into adjustments to increase net income of 3,416 million THB and adjustments to decrease net income of 5,084 million THB. Total impact to the net income as an absolute value is 8,500 million THB. The result is in the same direction as the above result on the numbers of adjustment transactions. The number of adjustments to decrease net income is more than the number of adjustments to increase net income. The amount of net income impact is larger for the decreasing side than the increasing side. Financial statements preparers and the audit committee should pay more attention to overstated net income transactions.

Levels of adjustments



From the total of 1,989 transactions, 75% of the adjustments are at the parent company level, while 20% are at the subsidiaries for the purpose of preparing consolidated financial statements. The results indicate that without the complexity of consolidation process with many subsidiaries, companies are still facing financial statements adjustments. Although the complexity in the process of financial statement preparation can contribute to adjustment transactions, it is not the main reason for the adjustments. Those in charge of preparing financial statements should beware of potential misstatements even though the company does not have any subsidiary.

Frequently Adjusted Accounts as Categorized into Recurring and First Time Adjustments

55.03% of adjustments are recurring

- **Accounts Receivable (7.25%)**
- Accounts Payable (6.74%)
- Income Taxes (5.31%)
- Selling and Administrative Expense (4.53%)
- Other Current Assets (4.45%)

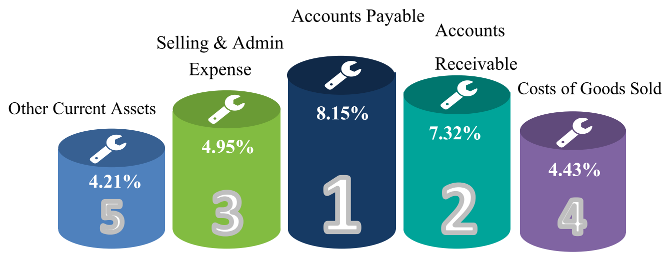
44.97% of adjustments are first time in 2018

- **Accounts Receivable (6.64%)**
- Selling and Administrative Expense (6.45%)
- Accrued Expenses (6.21%)
- Cost of Goods Sold (5.03%)
- Accounts Payable (4.98%)

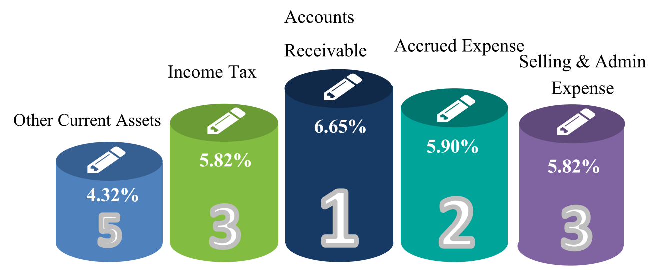
More than half of the adjustment transactions are recurring transactions. Financial statements preparers should have known the adjustments from the previous years mistakes. With proper communication within the company and the attentiveness from those who are responsible for the financial statements, these adjustments could be prevented.

When consider top 5 accounts from recurring and first time adjustments, both recurring and first-time adjustments relate to accounts receivable account the most. All companies should pay more attention to this account.

Accounts Proposed by Auditor

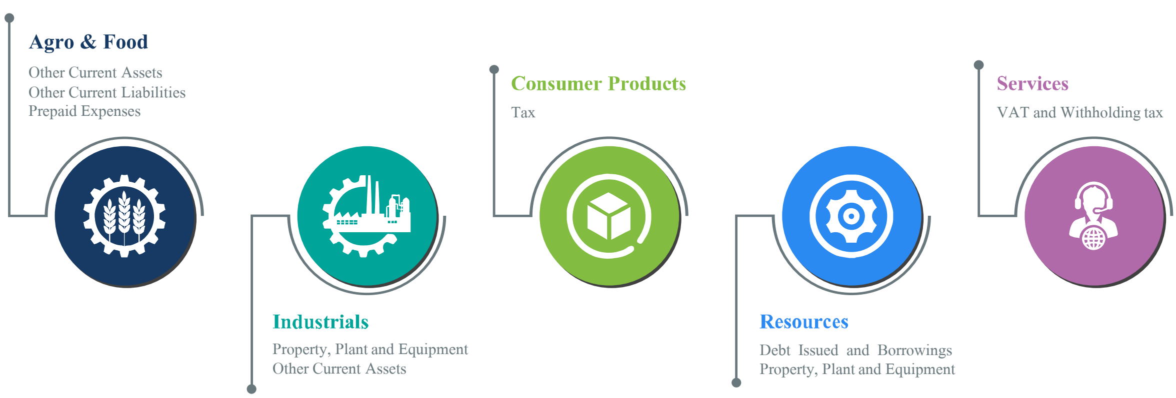


Accounts Proposed by Client



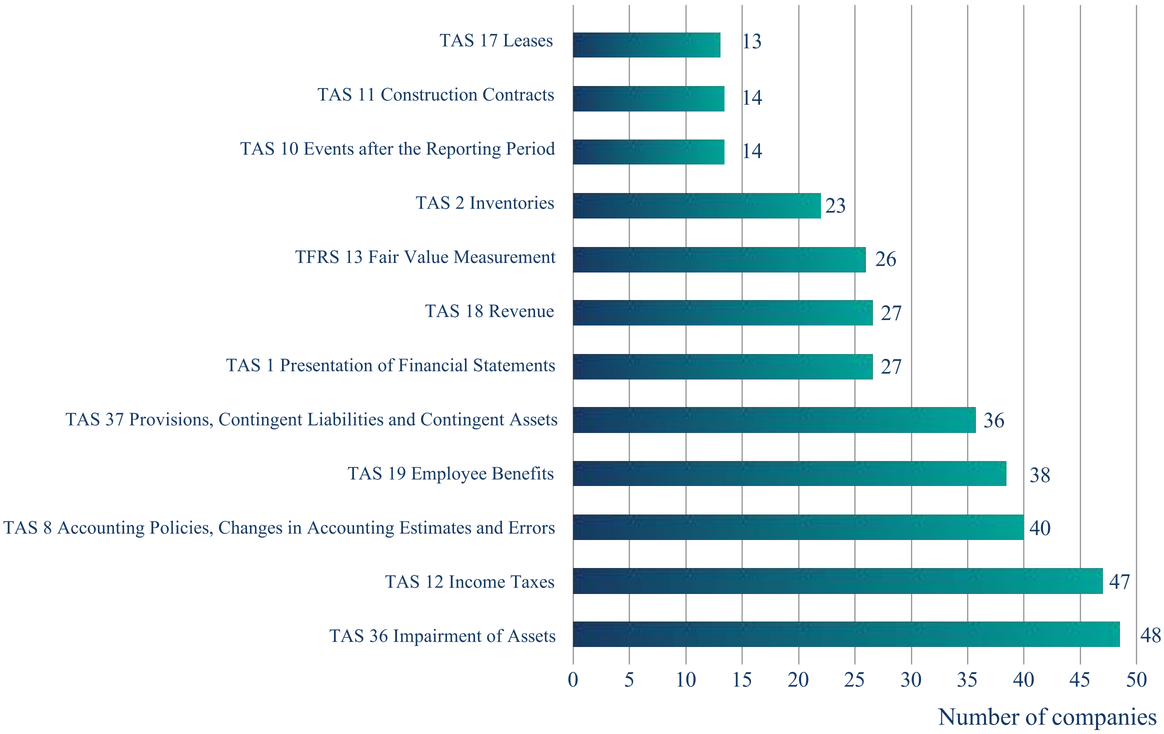
In the details of adjustments by accounts, *accounts payable is the account that auditors propose for adjustments the most.* The second most proposed adjustment by auditors is *accounts receivable,* which is the most proposed adjustment by financial statements preparers. Selling and administrative expense is one of the top most adjusted accounts by both auditors and financial statements preparers. Income tax is the third most adjusted account by financial statements preparers. From the interview with auditors and financial statements preparers, whenever there is an adjustment that changes revenue or expense, there will be an impact on income tax. Financial statements preparers will adjust tax amount even though the amount is not material to auditors. The reasons for income tax adjustments are the concern about tax audit by the Revenue Department and the accuracy of the carry forward balances.

Important Misstated Accounts by Industry



When investigate the adjustments by industry, each industry has different areas of misstated accounts. The consumer products industry usually adjusts tax account, while resources industry, with huge fixed assets balances and complexity of fixed assets, faces the adjustments on property, plant and equipment account. Services industry, without tangible product, has to rely on contracts to recognize revenue and has adjustments about VAT and Withholding Tax account. When those in charge of financial statements have information about these frequent mistake accounts in their industry, they can put more attention into these areas to prevent adjustments.

Accounting Standards that the Financial Statements Preparers Believe to be the Cause of Adjustments



The survey asks which accounting standards the financial statements preparers consider to be the top 3 reasons for financial statement adjustments. *TAS 36 Impairment of Assets* is voted by financial statements preparers as the most likely accounting standard that causes financial statement adjustments. Other top voted standards are *TAS 12, TAS 8, TAS 19, and TAS 37*. However, the adjustment information from auditors does not indicate the problem with impairment of assets. The results are agreed with the reasons of adjustments as seemed by financial statements preparers. Financial statements preparers believe that the main reason of adjustments is *accounting estimates and judgment,* which are important parts of determining asset impairment. It is possible that TAS 36 has been adopted for quite a period of time. Most mistakes are detected and corrected. The accounting standards ranked 3rd, 4th, and 5th as most likely to be the reason of adjustments are also related to accounting estimates and judgment. For TAS 12 Income Tax, the results also show that tax is an important issue in the financial statements adjustments. Auditors also indicate in the interviews that the financial statements preparers are uncertain about tax accounts and wait to discuss with the auditors before recording tax transactions.

Results from Multiple Regressions

Adjustment & Reclassify	Only Adjustment	Auditor Detect
- Accounting Department Compensation - The Proportion of Independent Directors in the Board of Directors - Internal Audit Function - Company Age	- Accounting Department Compensation - Internal Audit Function - Company Age - Audit Partner Tenure - Big 4 Auditor	- Internal Audit - The Proportion of Independent Directors in the Board of Directors - Company Size - Subsidiary Number

Results from Multiple Regressions This study conducts 3 models of multiple regressions to find the relationship between the numbers of financial statements adjustments and factors possibly relate to the numbers of financial statements adjustments. The independent variables in the 3 models are as followings:

1. The number of all financial statements adjustments including reclassify
2. The number of financial statements adjustments without reclassify
3. The number of financial statements adjustments detected by auditors (without client detect)

The results from all multiple regressions models show that firms that have their *own internal audit function face lower numbers of audit adjustments*. This result may indicate that the in-house internal auditor has better internal information than the outsource internal auditor. After interviewing with the companies and auditors, the explanation for this result can be that in-house internal auditors have only one company to focus on. Therefore, they can put more effort and attention into their company than outsource internal auditors with many clients. In addition, they can follow up the comments from auditors to reduce the chance that the company will not make the same mistake again. Outsource internal audit professions can bring expertise from providing services to many companies. However, usually the outsource audit function focuses only on operation aspect rather than financial statement preparation process. Further study on the relationship between internal audit function and the quality of financial statements in Thailand should be conducted to gain a better understanding of the relationship.

The compensation that the company provides to support accounting function has the negative relationship with the number of adjustments in the 1st and 2nd models. This result may support that the amount of resources for the accounting departments has an impact on financial statements quality. The amount of budget for accounting function may present how the executives view accounting function. With the strong support from executives to accounting function, financial statements may contain fewer mistakes and thus, fewer adjustments.

The *proportion of independent directors to total numbers of directors*, which can be a proxy of corporate governance level, has *a negative relationship with the number of audit adjustments* in model 1 and 3. Firms with good corporate governance as reflects in the higher proportion of independent directors may pay higher attention to high quality accounting report resulting in lower number of adjustments.

Firm age has *a negative relationship with the number of audit adjustments* in model 1 and 2. The experience gained from preparing financial statements for a period of time may increase the reporting quality. The understanding of related accounting standards in that industry may increase overtime. Firms that have established for a *longer period of time* have *fewer audit adjustments*

In model 2, when using only adjustments (not reclassify), *Big 4* has a *negative relationship with the number of adjustments.* Firms with non-Big 4 auditors have more adjustments than firms with Big 4 auditors. The interpretation of the results can be in both client and auditor factors. For client factor, holding auditor factors constant, the interpretation can be that firms that select Big 4 auditors are firms that have higher reporting quality. As a result, without auditor factors, these firms innate fewer mistakes that require audit adjustments. For auditor factor, holding original accounting quality constant, non-Big 4 auditors may be able to detect more mistakes in the financial statements that require audit adjustments.

For *audit partner tenure, the relationship with the number of adjustments without reclassify is in the opposite direction*. Firms that stay with the same audit partner for a longer period of time have fewer adjustments than firms that just change the auditor. From the interview, some auditors comment that even though the audit partners are from the same audit company, they can have different opinions. Therefore, when there is an auditor rotation, there will be a high chance of audit adjustments. While firms that stay with the same auditor for a longer period of time can learn from the auditor and lower the chance of repeated mistakes. The results can also be interpreted in another direction, if holding original financial statement quality stable, as that the longer the auditor stays with the same client, the level of tolerance towards the mistakes is increasing. The auditor may re-evaluate risk levels of the client and understand client’s risks better.

Firm size also has a negative relationship with the number of adjustments detected by auditors. Larger firms have lower adjustments than smaller firms. Larger firms may have more resources to invest in accounting systems resulting higher quality accounting system.

The *number of subsidiaries have a positive relationship with the number of adjustments* detected by auditors. Companies with more subsidiaries have a higher chance to have more adjustments. From the interviews with auditors and financial statements prepares, the number of subsidiaries can indicate the complexity in the accounting system. There is a chance that information from these many subsidiaries may arrive at the parent company after closing the accounts. Moreover, the auditors who audit parent company accounts need to wait for the audit results from subsidiaries auditors. If there is a material misstatement at the consolidation level, the auditors of parent companies are required to make adjustments.

Suggestions. From the results, *tone at the top* plays an important role in reducing financial statements adjustments. Accounting department alone cannot get enough cooperation from other departments to send information for the preparation of financial statements in time. The management and those in charge of governance need to communicate with other departments to reduce the number of financial statements adjustments. The main reason of adjustments is *an inaccuracy in gathering or processing data or factual misstatements* rather than judgment. Moreover, more than half of the adjustments are *recurring adjustments*. The company should set up a *KPI* about financial statements adjustments in order to send the signal to all departments about the importance of having the correct financial statements prepared by the accounting department. The financial statements are benefit external users. At the same time, financial statements provide information that is important to management in making decision and planning.

Suggestions from the Results

Companies should also arrange to have *internal audit and internal control functions* not only for operations, but also for the preparation of financial statements.

The *understanding of accounting standards* has a direct impact on the quality of financial statements prepared by the accounting department. The executive should encourage accounting staffs to attend seminars to learn and share knowledge among colleagues in the department.

The adjustments are *unique by industry*. There should be *CFO Club* or *Accountant clubs* in each industry to *share knowledge* about specific issues within each industry.

The SEC should set up a *knowledge sharing platform* to share case studies so that the companies can learn from other companies experience and get advice from SEC. This platform should provide answers to frequently asked questions so companies with the same situation can find an appropriate solution.

Some financial statements adjustments are from the accounting staffs wait for the auditor to provide consulting on the adjustments. These adjustments can impact audit plan since they can impact the materiality level that the auditors set before the adjustments. The financial statements preparers should *communicate with the auditors or SEC* before the ending of the fiscal year. However, the executives and the accounting department must take responsibility for the accuracy of the financial statements. They should not rely on the auditors to provide the final numbers. If there are some complex issues, the company should consider hiring an accounting consultant rather than ask the auditor, which can create the auditor independent issue from determining and auditing these numbers.

For the *lateness of information* sent to the accounting departments, the company should prepare the *manual for fiscal year end closing process*. The manual should contain a *checklist of documents* that the accounting department needs to obtain, the responsible party of each document, and the deadline to submit each document. This suggestion will work only when the executives and audit committee help communicating this information to all departments in the company.

Key Takeaway

01 Most adjustments are factual

02 Review and communication are keys

03 Industry specific accounting treatment

04 Mitigate the recurring

Conclusion The factors that relate to the number of audit adjustments are from ***financial statement preparer, auditor, and corporate governance***. The main reason of adjustments is *factual misstatements* and more than half of the adjustments are *recurring adjustments*. Most frequent adjusted accounts are *unique* upon each industry. To reduce financial statements adjustments, the management and those in change of preparing financial statements plays an import role to encourage the *communication* within the organizations and with the auditor, and *review* the financial statements before submitting them to the auditor. The understanding of natures of and factors related to audit adjustments will help all parties to put their effort into the right place to prevent, detect, and correct errors and misstatements in the financial statements. Consequently, the number of audit adjustment will decrease and the quality of financial statements will increase.