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THE ROLE OF INTERNATIONAL AUDITING STANDARD NO. (315) TO IDENTIFY THE RISKS OF MISSTATEMENT BY REVEALING EARNINGS MANAGEMENT PRACTICES

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Abstract. This research aims to identify the role of International Auditing Standard No. (315), identifying and estimating the risks of material misstatement through understanding the facility and its environment in detecting earnings management practices. The results showed that identifying and estimating the risks of material misstatement through understanding the facility and its environment helps the auditor detect earnings management practices that have a major role in misleading financial statement users about the true outcome of the activity. As well as the departments that practice earnings management usually possess high accounting expertise. The study recommended that the transparency of financial statements must be improved and the quality of financial reports must be raised through adequate and fair disclosure. In addition to reducing the level of information asymmetry between management and users of the financial statements to provide confidence in those lists. Auditors are interested in calculating total receivables and regular and extraordinary receivables on a regular basis to present profits fairly. Also to disclose the quality of profits in financial reports, which helps users of financial statements predict future profits fairly.

Key words: International Auditing Standard (315); risks of material misstatement ; earnings management

Introduction

The International Auditing Standard No. (315) was published with the intention of establishing norms and offering direction on how to acquire an understanding of the business and its surroundings, including its internal control. Concerning the evaluation of the risks of fundamental errors in the process of auditing financial statements, the standard emphasized that the auditor must obtain an understanding of the facility and its environment, including its internal control, that is sufficient to identify and evaluate the risks of fundamental errors in the financial statements, regardless of whether they are the result of fraud or error by Zarza-Herranz et al, 2020. A sufficient amount to create and carry out additional audit processes. In the course of the auditing process, it is important to emphasize that acquiring this understanding is a process that is ongoing and dynamic, consisting of information collection, updating, and analysis. Therefore, in the process of carrying out risk assessment processes, the auditor is able to acquire audit evidence about categories of transactions, account balances, or associated disclosures and

evidence, which provides a foundation for the process of creating and executing remedies by Callao et al, 2021and Liu et al, 2021 . The potential for material misrepresentation of financial statements, intentional misrepresentation, and manipulation of declared profits through the utilization of accounting methods, whether within the framework of accounting standards and principles or outside of them, in order to accomplish particular objectives and gratify particular desires (Garfatta , 2021; Algrady et al, 2022).
The opinion of the auditor on the financial statements is regarded to be a summary of the audit process, and it is relied upon by a large number of important parties, including shareholders and investors. To be able to provide an opinion on the financial statements, the auditor must either identify misstatements and earnings management practices that undermine the fairness of the financial statements or fail to detect them. This is necessary in order for the auditor to be able to provide an opinion. It is important to acknowledge the significance of International Auditing Standard No. (315). By gaining an awareness of the facility and the environment in which it operates, one may identify and estimate the risks of material misstatement in the process of identifying earnings management procedures. In terms of studying their relative importance and their impact on the financial statements, as well as increasing the effectiveness of the auditor's professional performance to detect earnings management practices, the research is significant because it sheds light on the mechanism for identifying the risks of misstatements. This is the reason why the research is so important. (International Auditing Standard No. 315: Identifying and analyzing the risks of material misstatement via knowing the company and its environment aids the auditor in detecting earnings management activities) This hypothesis serves as the foundation for the study that is being conducted.

Literature review

When it comes to financial statements, earnings, also known as "net income," is the single most significant item, and in the majority of situations, it is the primary aspect that investors consider when making decisions. The majority of the time, businesses have a tendency to be weighted down by the expectations of the market about their earnings. In the event that earnings are significantly different from what is anticipated by the market, this can have a negative impact on the stock price of the firm and hinder its ability to bring in further funds in the future. According to Goel (2012), given the importance placed on profits, managers of companies are constantly interested in the reporting of results and take into consideration the many options available for reporting earnings. It is the intervention of managers in the process of financial reporting that gives rise to earnings management. In their research, Fakhfakh et al, (2011) sought to analyze the "agency theory" in order to provide an explanation for the motivation behind the management of profits. The principal, who are the shareholders, and the agents of the principal, who are the managers, are in conflict with one another because of the disparities in their aims and their willingness for risk. It is possible for shareholders to provide incentives to managers by tying their remuneration with accounting profitability in order to lessen the likelihood of this conflict occurring. When it comes to manipulating earnings through the use of a variety of innovative accounting practices, this linking of remuneration with earnings has frequently proven to be the most powerful motivation for managers. According to Ghaleb et al, (2020), managers have been given the ability to select from a variety of alternative methods of accounting for transactions, as well as the ability to select from a variety of choices that fall under the same accounting approach. This flexibility has been created to enable managers to adjust to economic conditions in the most effective manner possible and to provide an accurate depiction of the adverse effects that transactions have on the economy. This freedom, however, is utilized by managers in an opportunistic manner, with the intention of "manipulating" the available options for their own personal benefit. The capacity to control these options and arrive at the targeted amount of profits is the basis of what is referred to as "earnings management." Another definition of earnings management offered by Awuye et al, (2022) is that it is "opportunistic," meaning that managers manipulate earnings in order to acquire personal benefits by acting in an opportunistic manner. Recent years have seen a significant increase in the amount of attention paid to earnings management, as is obvious from the research that is now being conducted in this field. It has been demonstrated via previous research that earnings management is a prevalent practice. On the other hand, the majority of the research that have been conducted on earnings management have focused its attention on the reporting methods of widely owned firms in industrialized nations, notably the United States. Despite the fact that there is a small amount of literature available on emerging economies, there is evidence that suggests a higher degree of earnings intervention in developing nations in comparison to their developed counterparts (Мюллер et al, 2022; Musallam et al, 2020). It is possible for opaque reporting procedures and poor profits quality to have a negative impact on equities markets in emerging nations at a time when there is an increased interconnectedness of financial markets throughout the world. The East Asian crisis that occurred is an example of how inadequate governance measures and poor accounting disclosure quality contributed to the collapse of stock markets (Choi et al, 2022; Kirana et al, 2020). According to Mnif et al, (2021), one of the challenges that financial analysts, investors, and corporate executives face is determining how to differentiate between earnings manipulation that ultimately turns out to be fraudulent and the day-to-day struggles of managers to meet pre-determined targets by utilizing a variety of accounting flexibilities. According to Almarayeh et al. (2022), earnings management is made feasible through the manipulation of accruals. The term "accruals" refers to the earnings component that does not create cash flows. Accruals that are required by the circumstances of the business are referred to as non-discretionary accruals (NDA), and they have a tendency to reverse out in following quarters. When it comes to earnings management, the majority of research have concentrated on discretionary accruals (DA), which refers to the part of accruals that are made via the deliberate involvement of managers in the process of financial reporting. DA is also taken into consideration as a stand-in for "earnings management" in this most recent study. The difficulty that is involved in identifying manipulation of financial information from publicly available financial statements is one of the most significant issues that are associated with earnings management. There is neither visibility nor transparency in the handling of earnings. All of the tests that are supposed to quantify earnings management may, at most, be defined as near approximations by virtue of the fact that earnings management is intrinsically unobservable. In order to estimate profits management, a number of different models have been created throughout the course of the years. According to Chowdhury et al, (2021), the majority of models center their attention on the utilization of aberrant or discretionary accruals as a proxy for earnings management. In contrast to the more straightforward models, which quantify DA as total accruals, the more complex models make an effort to break down total accruals into components that are either discretionary or non-discretionary (Zehri et al., 2020). Earnings restatement, financial reporting fraud, and inspection of particular accruals and allowances are some of the other methods that are frequently utilized in the process of evaluating earnings management (Alia et al., 2020). In the earlier, more straightforward models developed by Sitanggang et al, (2020) , the assumption was made that NDA would remain unchanged throughout the course of time periods. The change in total accruals between two periods was used as a surrogate for DA. A criticism was leveled against these models because of their too simple assumption that the NDA does not change between the estimate period and the event period. According to Vagner et al, (2021) proposal, these models may be improved by lowering the assumption that the NDA would remain constant. Using the Jones model, an attempt is made to adjust for the effects that the economic circumstances of a firm have on NDA. According to Jones, the factors that determine the NDA include variations in total assets, gross income, and gross property plant and equipment (PPE). On the other hand, the Jones model was not exempt from criticism either. Soyemi et al. (2020) made several modifications to the original Jones model. While doing so, they highlighted that one of the limitations of the Jones model is that it assumes that sales revenue is completely uncontrolled. As a consequence, any change in sales will result in non-disclosure agreements (NDA). When managers accumulate revenues that are neither produced nor received in cash, this is an example of successful revenue management. Because of this, there would be a shift in both the revenues and the receivables. In the modified Jones model, the change in receivables that might occur as a result of a change in revenues is taken into consideration. When compared to the Healy model, the DeAngelo model, the Jones model, and the industry model, the modified Jones model is the most generally used empirical model and offers the most powerful test of earnings management (Savitri et al., 2020). This applies to all of the models that are currently accessible. Gandía et al, 2021 come to the same conclusion, which is backed by their findings. For their empirical analysis of profits management in Indian enterprises, Thoppan et al. (2021) and Herranz et al, 2022, selected the modified Jones model (1995), which is the model that is used in the current study using the modified Jones model. In order to arrive at the DA component, the modified Jones model employs a phased approach, which has been detailed in detail in the part that discusses the study methodology.

Research methodology

1. Measuring and examining the facility’s financial performance

Management will measure and examine those matters they consider important. Performance indicators - whether external or internal - create pressures on the facility, and thus these pressures may motivate management to take action to improve the facility’s performance, or to distort the financial statements. Therefore, understanding an organization's performance metrics helps the auditor take into account whether pressures to achieve targeted performance may push management to take actions that increase the risks of material misstatement, including those resulting from fraud.

Measuring and examining financial performance differs from monitoring controls, although their purposes may overlap:

- The measurement and examination of performance is directed towards whether the facility's performance has achieved the total objectives set by management (or third parties).

- The follower of controls is particularly concerned with the effective operation of internal control.

However, in some cases, performance indicators also provide information that enables management to identify deficiencies in internal control.

Examples of internally produced information that management uses in measuring and examining financial performance, and which the auditor may take into account, include:

- Key performance indicators (financial and non-financial), key ratios, trends and operational statistics.
- Financial performance analyzes period after period.
- Budgets, forecasts, analysis of deviations, information related to sectors and divisions, and performance reports at the division or any other level.
- Employee performance measures and compensation policies through incentives.
- Comparing the facility's performance with that of its competitors.

External parties can also measure and examine the financial performance of the facility. For example, external information, such as analyst reports and credit rating agency reports, may represent useful information for the auditor. In most cases, such reports can be obtained from the facility being audited.

2. Earnings management

The concept of earnings management

Accounting information is the basic foundation of financial statements, so accountants and financial managers paid attention to the necessity of presenting accounting information in a clear and appropriate manner and disclosing all financial information through published financial statements, as they are considered one of the most important sources that users rely on in making decisions (Barth, 2007:29). Determining the dimensions and scope of various earnings management activities requires defining the concept of earnings management, as it is management's intended attempts to manipulate announced profits by using flexibility in choosing among accounting methods or accelerating or postponing the recognition of expenses or revenues (Michael et al, 2007:2). (Scott & Pitman, 2005:5) defined it as the use of various methods of deception or tricks to distort images of real financial performance in order to achieve desirable results. As defined by (Jassim, Muhammad, 2011: 450), earnings management is the use of accounting techniques in dealing with economic events in light of the application of accounting standards with the aim of arriving at financial statements that express the good performance of the facility during the financial period in a way that serves the goal of management and improves the strength of this facility in market ..

Motives for earnings management

When preparing financial statements, management seeks to achieve two main goals: (Al-Hindi, 2015: 32)

1- Achieving special benefits for management, whether in the present or the future, as this motive is considered opportunistic
2- The continuation of economic unity and its survival in the competitive market through optimal exploitation of available resources and achieving a balance between the degree of risk and return, and the motivation is the efficiency of the facility.

There are many motives that urge management to practice profit management to influence the declared profit number to reach the target profit. Among these motives are:

First: Motives related to expectations and evaluation of the financial market

The prevalent use of accounting information by financial analysts and investors to help evaluate stocks can create an incentive or incentive for managers to manipulate earnings to influence stock price performance in the short term

3. Contractual motives

Agency theory describes the company as a set of contractual relationships and its existence is achieved through one or more contract agreements. This creates a problem of conflict of interest between management, creditors, and shareholders, and this results in multiple contractual costs, such as the costs borne by management to reduce the conflict of interest and the costs of monitoring management's behavior by the owner. Therefore, contracts are resorted to in order to reduce the negative effects of the conflict of interest between shareholders and management. And between shareholders and creditors (Shaalan, 2016: 11)

4. Tax motives

The administration resorts to choosing alternative methods and policies that reduce taxable profits in order to pay less taxes, in addition to storing profits in prosperous years in order to increase these profits in bad years. (Hammad, 2005: 53)

Reasons for managing profits

There are many reasons for the administration to follow an income smoothing policy and strategy, including:

1- Stability of the dividend distribution policy, which is desirable to develop and maximize investor confidence in the performance and efficiency of management.
2- Developing and strengthening the relationship between employees and management. A sharp increase in declared profits can lead to higher wage demands from employees.
3- Reducing the tax burden through timing the realization of items of expenses and revenues over a number of fiscal periods.
4- The income smoothing policy can have a psychological impact on the economy.

Results and discussion

Two companies listed on the Iraq Stock Exchange, namely Al-Mamoura Real Estate Investment Company and Al-Amin Real Estate Investment Company, were selected to apply International Auditing Standard No. (315) to identify and estimate the risks of material misstatement through understanding the facility and its environment in disclosing earnings management practices. Total receivables and regular receivables will be calculated and then find the difference between them and calculate the operating cash ratio and return on assets from cash flows for the purpose of measuring the quality of profits for the research sample companies for the three years. (2021, 2022, 2023) and as follows:

1. Financial statements of the companies in the research sample

Table 1. Financial statements of companies

Al Mamoura Real Estate Investments Company						
Cash flow from activities	Total assets	Fixed assets	Short-term credit	Net operating income	Revenue from current activity	Statement Year
1246	25739	21	942	1406	1210	2021
1488	25344	15	1031	807	801	2022
2776	25783	10	184	419	392	2023
Al-Amin Real Estate Investments Company						
3842	17141	5877	9833	185	171	2021
9312	13857	2762	319	6383	140	2022
8969	13786	68	339	125	57	2023

2. Calculating the total dues

It is calculated by the difference between net income and cash flow from operating activities Total receivables = net operating income - cash flow from operations

Total dues to Al-Mamoura Real Estate Investment Company for the years: 2021 (160), 2022 (-681), 2023 (-2357)

Total dues to Al-Amin Real Estate Investment Company for the years: 2021 (3657), 2022 (2929), 2023 (8844)

3. Calculating regular dues

Ordinary receivables = (current activity revenue - short-term credit) ÷ fixed assets

Regular dues to Al-Mamoura Real Estate Investment Company for the years 2021 (-12.8), 2022 (-15), 2023 (20.8)

Regular dues to Al-Amin Real Estate Investment Company for the years: 2021 (1.64), 2022 (0.06), 2023 (4.14)

4. Calculating extraordinary receivables

Extraordinary receivables = total receivables - ordinary receivables

Extraordinary dues to Al-Mamoura Real Estate Investment Company for the years 2021 (147), 2022 (696), 2023 (-2336)

Extraordinary dues to Al-Amin Real Estate Investment Company for the years: 2021 (-3658.64), 2022 (-2929.06), 2023 (-8848.14)

Table 2. Average of extraordinary accruals

Al Mamoura Real Estate Investments Company			
Abnormal dues	Normal dues	Total dues	Statement
147	(12.8)	160	2021
696	(15)	(681)	2022
(2336)	20.8	(2357)	2023
(1493)			Total
(497)			Average
Al-Amin Real Estate Investments Company			
)(3658.64	(1.64)	(3657)	2021
(2928.94)	(0.06)	(2929)	2022
(8848.14)	(4.14)	(8844)	2023
(15435.72)			Total
(5145.24)			Average

5. Calculating the operating cash ratio

Operating cash ratio = net cash flow from operating activities ÷ net operating income

Al-Mamoura Real Estate Investment Company's operating cash ratio for the years 2021 (0.89), 2022 (1.84) ,2023 (6.62).

Operating cash ratio for Al-Amin Real Estate Investment Company for the years: 2021 (20.76), 2022 (1.45), 2023 (71.75)

Table 3. Average operating cash ratio

Operating cash ratio of Al-Amin Real Estate Investments Company	Operating cash ratio Al Mamoura Real Estate Investments Company	Statement
20.76	0.89	2021
1.45	1.84	2022
71.75	6.62	2023
93.96	9.35	Total
31.32	3.17	Average

6. Calculating the return on assets from cash flows

Return on assets from cash flows = net cash flow from operating activities ÷ total assets

Return on assets from the cash flows of Al-Mamoura Real Estate Investment Company for the years / 2021 (0.048),
2022 (0.058), 2023 (0.107)

Return on assets from the cash flows of Al-Amin Real Estate Investment Company for the years
/ 2021 (0.225), 2022 (0.67), 2023 (0.65)

Table 4. Average return on assets from cash flows

Operating cash ratio of Al-Amin Real Estate Investments Company	Operating cash ratio Al Mamoura Real Estate Investments Company	Statement
0.22	0.048	2021
0.67	0.058	2022
0.65	0.107	2023
1.54	0.213	total
0.51	0.071	Average

7. Interpretation of results

After doing the calculation for the normal receivables, the findings for Al Mamoura Real Estate Investments Company were as follows: In the years 2021 and 2022, respectively, it turned out to be somewhat negative (12.8), while in the year 2023, it turned out to be positive (20.8). For the years 2021, 2022, and 2023, respectively, the results for Al-Amin Real Estate Investment Company indicated that they were negative (1.64), (0.06), and (4.14). The results for Al-Mamoura Real Estate Investment Company for the years 2021 and 2022, respectively, showed positive (147) and (696), which shows a high quality of profits. These results were obtained by calculating the exceptional accruals, which express the quality of profits. The fact that it was negative (2336) in 2023 is indicative of a drop in the quality of earnings for that year. The negative value of the average extraordinary receivables (497) is indicative of a bad quality of profits given that this value is negative. A bad quality of profits is shown by the fact that the results for Al-Amin Real Estate Investment Company for the years 2021-2022-2023 showed negative values (3658.64), (2928.94), and (8848.14) consecutively. Additionally, the average extraordinary receivables (5145.24) was negative, which suggests that the company's revenue was negative.

Through the utilization of the operational cash ratio, the outcomes for Al-Mamoura Real Estate Investment Company for the years 2021, 2022, and 2023 were found to be favorable, with respective values of 0.89, 1.84, and 6.62. Due to the fact that the average was 3.17, it can be deduced that each dinar of net income results in 3.17 dinars of net cash flows from operational activities throughout the course of the three years. The outcomes for Al-Amin Real Estate Investment Company for the years 2021-2022-2023 were all favorable, with the average being
31.32. The results for each of these years were successively (20.76) (1.45), (71.75), and (20.76). This suggests that for every dinar of net income, there is a corresponding net cash flow of 31.32 dollars resulting from operational operations throughout the course of the years. Three of them. After doing the calculation to determine the return on assets from cash flows, the findings for Al-Mamoura Real Estate Investment Company for the years 2021, 2022, and 2023 indicated that the return was positive, with values of 0.048, 0.058, and 0.107 years accordingly. This

shows that every dinar invested in the company's assets creates (0.071) dinars of net cash flows from operational operations over the course of the three years. The average return rate was 0.071, and this indicates that the return rate was achieved. The results for Al-Amin Real Estate Investment Company for the years 2021-2022-2023 showed favorable results, with the average return rate being 0.51 and the results being successively 0.22, 0.67, and 0.65. It can be deduced from this that each dinar that is invested from the assets of the firm results in the generation of (0.51) dinars from the net. These are the cash flows that result from operating operations over the course of three years.

Conclusions

Identifying and estimating the risks of material misstatement through understanding the facility and its environment helps uncover earnings management practices. The practice of earnings management plays a major role in misleading users of financial statements about the reality of the outcome of the activity, and that the departments that practice earnings management usually have high accounting expertise. The total receivables of Al-Mamoura Real Estate Investment Company for the year 2021 are high due to the increase in net operating income, and they were low in the years 2022 and 2023, respectively, due to the decrease in net operating income, and their impact is significant in determining the quality of profits. As for the total receivables of Al-Amin Real Estate Investment Company, they were low in the years 2021, 2022, and 2023, respectively, due to the decrease in net operating income, and their impact is significant in determining the quality of profits. Al-Mamoura Real Estate Investments Company’s regular receivables were low in the years 2021 and 2022 due to the decrease in fixed assets. As for Al-Amin Real Estate Investment Company, it was low in the three years. The extraordinary receivables of Al-Mamoura Real Estate Investment Company, which represent the quality of profits, as they were positive in the years 2021 and 2022, and this indicates the quality of profits. In 2023, it was negative, and this indicates a decline in the quality of profits. As for Al-Amin Real Estate Investments Company, it was negative for the three years, and this indicates a low quality of profits. The transparency of financial statements must be improved and the quality of financial reports must be raised through adequate and fair disclosure, in addition to reducing the level of information asymmetry between management and users of the financial statements for the purpose of providing confidence in those lists. The auditors’ interest in calculating the total receivables and regular and extraordinary receivables periodically to present profits fairly. Disclosing the quality of profits in financial reports helps users of financial statements predict future profits fairly. Publishing internal periodic reports on the quality of profits in economic units for the purpose of increasing efficiency and improving performance. Holding conferences and seminars to raise the efficiency of regulatory bodies, which show the means and methods used by departments to detect profit management practices.

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