

ACCOUNTING REGULATION AND ENFORCEMENT MECHANISMS: THE AUDITOR'S ROLE IN THE PORTUGUESE LISTED GROUPS*

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RESUMO

Em Portugal não existiu regulamentação sobre informação consolidada até 1991, quando foi publicado o Decreto-Lei nº 238/91, de 2 de Julho, que transpôs para o ordenamento jurídico-contábil português as normas de consolidação de contas estabelecidas na Sétima Diretiva Comunitária (83/349/CEE). Surgiu assim a obrigação geral de as empresas portuguesas sujeitas ao Plano Oficial de Contas (POC) elaborarem, divulgarem e publicarem contas consolidadas.

As entidades com funções de regulamentação na área contábil têm sido responsáveis pelo processo de elaboração das normas, enquanto os membros dos órgãos de direção e gestão das empresas são responsáveis pela informação contábil consolidada dos grupos. Os Revisores Oficiais de Contas (ROCs) podem desempenhar um papel importante, assegurando a correta aplicação das normas contábeis e contribuindo assim para a melhoria da qualidade da informação publicada.

O objectivo deste artigo é analisar o conceito de grupo e a extensão da aplicação das cláusulas

ABSTRACT

The purpose of this article is to examine the extent to which the clauses for the exclusion of subsidiaries from consolidation are used, in order to assess the degree of compliance with accounting regulation and the effectiveness of the statutory auditor as an enforcement mechanism in case of observed non-compliance.

The presentation of consolidated financial statements by Portuguese companies was not regulated in detail before the implementation of the EU's Seventh Directive and the general obligation to prepare consolidated accounts had not applied to Portuguese companies until 1991.

Regulators have been responsible for the endorsement of accounting rules and managers are responsible for the information disclosed by Portuguese companies regarding the scope of group accounting. In practice, the scope of consolidation depends on the judgment of makers and managers of the parent company. Auditors may play a key role in the process of guaranteeing the

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de exclusão de filiais do perímetro de consolidação, com o objectivo de avaliar em que medida as empresas cumprem as normas contábeis, e avaliar o papel dos Revisores Oficiais de Contas como mecanismo de *enforcement* em caso de não cumprimento.

Neste artigo analisam-se os relatórios e contas consolidados de todas as empresas-mãe com acções admitidas à cotação na Bolsa de Valores de Lisboa em 31 de Dezembro de 1999 sujeitas ao POC.

Concluiu-se pela diversidade, quanto ao conceito de grupo adoptado, tendo-se observado ser o controlo legal mais comum do que o controlo de facto para efeitos de determinação da obrigação de prestar contas consolidadas. Observou-se ainda que todos os motivos de exclusão de filiais da consolidação previstos na lei contabilística foram invocados pelos grupos, tendo a não-materialidade da filial sido a cláusula de exclusão mais invocada como motivo de exclusão. Em alguns casos de não divulgação da informação mínima exigida acerca do conceito de grupo adoptado, das sociedades incluídas e excluídas do perímetro de consolidação, não encontramos reservas ou ênfases nas certificações legais de contas nem nos relatórios dos auditores externos, concluindo-se, assim, que a importância do papel desempenhado pelos ROCs, assegurando a correta aplicação das normas contabilísticas e contribuindo assim para a melhoria da qualidade da informação publicada poderá ser aumentado.

Palavras-chave: Regulamentação contabilística; Perímetro de consolidação; Cumprimento; *Enforcement*; Revisor Oficial de Contas.

correct application of prevailing standards and thus encompassing the enforcement of accounting regulations and contributing to the quality of disclosed information.

Our sample includes the consolidated financial statements of all the Portuguese companies listed in the Lisbon Stock Exchange on December 31st for the year 1999, to which the Official Accounting Plan is applicable.

Our conclusion is that diversity exists among accounting practices regarding the adopted group concept and the use of the clauses for excluding subsidiaries from consolidation. The role of the auditors as enforcement actors seems to be minor, as we did find few qualifications in their audit reports in the cases of observed non-compliance with the accounting regulation.

Keywords: *Accounting regulation; Scope of consolidation; Compliance; Enforcement; Statutory Auditor.*

1. INTRODUCTION

The purpose of this article is to examine Portuguese accounting practices regarding the scope of consolidation and the use of the clauses of exclusion of subsidiaries from the consolidation in order to assess the degree of compliance with accounting regulation. We also analyze the effectiveness of the enforcement by auditors in case of observed non-compliance.

The sources of consolidated reporting requirements include the Official Accounting Plan (POC-*Plano Oficial de Contabilidade*), the Commercial Business Law (CSC-*Código das Sociedades Comerciais*), the Commercial Registry Law and the Securities Market Law. Some recommendations by the Order of Registered Statutory Auditors (OROC-*Ordem dos Revisores Oficiais de Contas*) and instructions by the Stock Market Authority (CMVM-*Comissão do Mercado de Valores Mobiliários*) are also relevant for group accounting reporting.

The Portuguese system of enforcement consists of various actors, institutional and professional bodies and a set of laws and sanctions: makers of the financial statements, general managers, auditors and audit board, general shareholders meeting, accountants' professional body (CTOC-*Câmara dos Técnicos Oficiais de Contas*) and auditors' professional body, stock market authority, courts, press and public information.

To the best of our knowledge, this article is the first empirical study about the consolidated accounts presented by Portuguese listed groups and enforcement mechanisms for their presentation. It was carried out with a sample of non-financial Portuguese companies listed in the Lisbon Stock Exchange at the end of 1999.

Our conclusion is that diversity exists among accounting practices regarding the concept of group adopted and the use of the clauses for exclusion of subsidiaries from consolidation. We found that Portuguese companies are disclosing both scarce and poor quality information with some groups not disclosing the minimum required information. Cases

of voluntary disclosure are rare. Auditors seem to play a minor role as enforcement actors, considering that we found few qualifications in their audit reports in the cases of observed non-compliance with the accounting regulation. The flexibility of the regulation concerning the concept of group and the absence of a legal definition of the principle of materiality causes difficulties in achieving the objective of group accounts which is to give a true and fair view of the group activity, its financial position, income and equity.

After this introduction, this article is structured as follows: Section 2 presents a brief overview of the Portuguese regulation of group accounting and its enforcement system. Section 3 contains the results of the empirical study. Finally, we finish with the Conclusion.

2. REGULATION OF CONSOLIDATED ACCOUNTING IN PORTUGAL

2.1. The obligation to consolidate: an overview

The entry of Portugal into the European Union (EU) led to a major reform of commercial and company law. The Company Law published in 1986¹ is the key amendment regulation in the field of company law, substituting the previous legislation². With regard to consolidated accounts, the Official Accounting Plan was amended to attend to the requirements of the EU Seventh Directive in July 1991³. According to this, group accounting became compulsory for Portuguese companies in line with international standards. All groups controlled by a parent company have the obligation to present consolidated accounts from January 1, 1991 onwards.

The scope of application of Portuguese consolidated accounts is the same as that established in the Seventh Directive. Corporations, limited liability companies and limited partnerships with shares must prepare consolidated accounts. In 1995, the obligation to present consolidated financial statements was expanded to partnerships and limited partnerships, whenever their partners and limited partners are corporations or private limited partnerships with have

¹ Decree-Law 262/86, of September 2, 1986.

² The previous Company Law dates back to 1888.

³ Decree Law 238/91, of July 1, 1991.

a public limited company as a general partner⁴. Parent companies that are not organized under one of the legal forms mentioned above are not obliged to present consolidated accounts.

The objective of group accounts is to give a true and fair view (*imagem verdadeira e apropriada*) of the group's activity, its assets, liabilities, financial position, income and equity of the undertakings included in the consolidation taken as a whole (POC, 13.2.2.a)⁵. The POC includes a brief summary of the objectives and qualitative characteristics of financial statements (POC, 3). The usefulness of information in the financial statement depends on relevance, reliability and comparability. These three characteristics, together with concepts, principles and accounting rules, make it possible to achieve the true and fair view objective.

The consolidated accounts encompass the balance sheet, the consolidated profit and loss statement and notes to the consolidated statements, together with the consolidated directors' report. These documents must be made public by depositing them at the Commercial Registry. For listed companies, there are some additional requirements about disclosure and publication of accounts⁶.

The Portuguese legislator decided to keep the obligation to consolidate to a *minimum* and to allow departures, if duly justified in the notes to the consolidated accounts. The general rule is that consolidating is mandatory for all groups controlled by a parent company.

Consolidated accounts contain information that complements the individual accounts of the parent company. The obligation to prepare consolidated financial statements and a consolidated director's report does not release a parent company from the obligation to prepare its individual accounts and director's report. However, groups with listed securities may ask the Stock Market Authority for an authorization not to publish both sets of accounts⁷.

Accounting law may exempt some groups from the obligation to consolidate, if justified in the notes. However, this exemption may not apply to listed companies.

The users specifically interested in consolidated accounts are investors, lenders, workers, suppliers and other creditors, government and other official authorities, and the public in general. Group accounts in Portugal are used mainly to inform shareholders or members but also to protect minorities. In contrast with the individual accounts, group accounts do not form the basis either for the calculation of the dividend payable to the shareholders of the holding company or for the tax calculation of income taxes⁸.

2.2. The accounting concept of group

According to the Portuguese accounting regulation, the concept of group includes the parent company and its subsidiaries. Associated companies are excluded from the group.

Figure 1 summarizes the concept of group and the methods of consolidation adopted by the Portuguese accounting regulation.

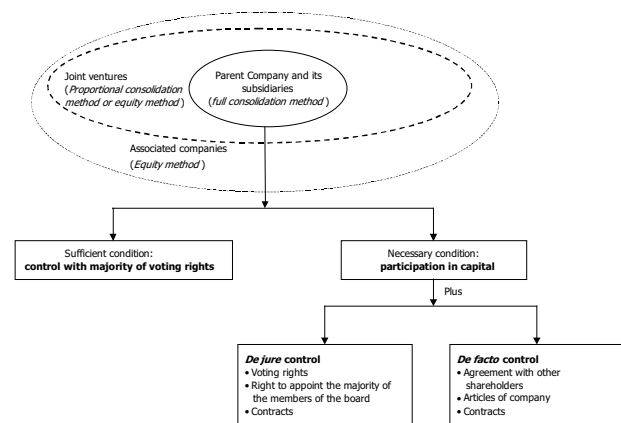


Figure 1 – The concept of group and methods of consolidation in the Portuguese accounting regulation

⁴ Decree-Law 127/95, of July 1, 1995.

⁵ According to Lee (1985) "true and fair view" has become a term of art. It is generally understood to mean a presentation of accounts, drawn up according to accepted accounting principles, using accurate figures as far as possible, and reasonable estimates otherwise; and arranging them so as to show, within the limits of current accounting practice, as objective a picture as possible, free from wilful bias, distortion, manipulation or concealment of material facts. In other words, the spirit, as well as the letter, of the law must be observed." However, this expression is hard to translate, since the concept is subjective.

⁶ Decree-Law 486/99 of November 13, 1999.

⁷ CSC, art^o. 65th e 508th ¼ A.

⁸ The fiscal consolidation is optional and the concept of group for fiscal purposes is tightened up.

The POC provides definitions of parent company, associated companies and other participation. A subsidiary is a company over which a parent company has the power of domination or control⁹.

Associated companies are enterprises in respect of which the parent undertaking holds, either directly or indirectly, a participating interest between 20 and 50 per cent of voting rights (POC, 2.7, e). The Portuguese accounting rules presume that associated companies can exercise significant influence over operational and financial policy. Nobes (2002) mentions that such a definition is much more vague (and more difficult to audit) than even the concept of "control", and consequently, guidance is needed if standardized practice is to result.

Other undertakings where participation is inferior to 20 per cent are out of the scope of consolidation and hence, they are valued both in individual and consolidated accounts at historic cost with a provision for depreciation, when necessary.

Both *de jure* and *de facto* control are relevant for the accounting definition of group, as the concept of group is based either on legal or economic control. This means that participation in shares of capital must exist in order to exercise control, but it is not necessary to own over 50 per cent of the voting rights to control a company. A minority of voting rights together with other mechanisms of control may be sufficient. However, Portuguese legislation does not include the option in art 12 of the Seventh Directive, which states that the controlling company does not need to be a shareholder.

The Portuguese law states that the criteria used to decide about the inclusion of a subsidiary in the consolidated accounts are based in control. Control exists when the parent companies hold, directly or indirectly, more than half of the voting rights of a subsidiary. However, control may exist when a parent holds half or less of the voting rights of an undertaking¹⁰ in any of the following situations:

- The right to appoint (name or remove) the majority of the members of administrative, executive or supervisory bodies of another company only applies when the parent undertaking holds a share of capital;

- The power to govern the financial and operating policies of the enterprise under a statute or an agreement, and the parent undertaking holds a share of capital;
- The power to appoint with its votes the majority of the members of the board of directors who hold office in the year in which the consolidated annual accounts are being prepared and in the preceding year, only when the parent undertaking holds a share of capital corresponding to less than 20 per cent;
- The power over more than one half of the voting rights by virtue of an agreement with other investors, and the parent undertaking holds a share of capital.

The obligation applies to companies having a participation in capital and includes direct and indirect participated companies held either by unique or multiple via. Own shares and own parts of capital lie outside the scope of consolidation.

The definition of a parent company in the POC envisages a simple majority of voting rights. In practice, however, differences exist in the case of non-voting shares or parts of capital and plural voting rights.

Portuguese consolidated accounts must include all the subsidiaries, regardless of where their registered offices are located¹¹, since Portuguese accounting applies the worldwide consolidation principle.

Different combinations of the *de jure* and *de facto* control criteria explain the possible variability of situations under which Portuguese companies are obliged to prepare consolidated accounts.

The full method of consolidation is the rule: it is applied in the consolidation of subsidiaries included. However, some subsidiaries ought to or may be excluded from the scope of consolidation.

2.3. Exclusions of subsidiaries from consolidation

The Portuguese accounting regulation states the conditions to exclude subsidiaries from the consolidation. Under certain circumstances, subsidiaries must be excluded, while the exclusion in other cases is optional.

⁹ POC, 2.7 and Decree-Law 238/91, art. 1st.

¹⁰ Decree-Law 238/91, art 1st, Nr. 1.

¹¹ Decree-Law 238/91, art 2nd, Nr. 2.

Figure 2 shows the criteria adopted by Portuguese accounting regulation for excluding subsidiaries from consolidation.

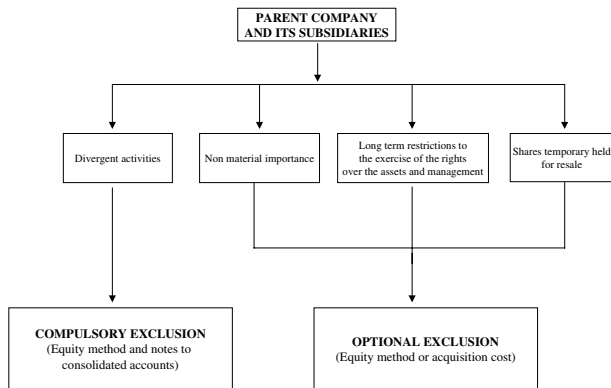


Figura 2 – Criteria for excluding subsidiaries from consolidation in Portugal

As required by the Seventh Directive, the Portuguese regulation requires that subsidiaries must be excluded from consolidation if their activities are so different from those of the other enterprises that their inclusion in the group accounts would be incompatible with the objective of providing a true and fair view of the assets, liabilities, financial position and profit and loss.

According to the Portuguese regulation, compulsory exclusion may not be applied merely because companies in the scope of consolidation reflect different activities, such as industrial, commercial or services unless divergence in activities is contrary to the true and fair view objective. However, the Portuguese regulation does not provide criteria to classify activities as different for the purpose of exclusion. Thus, this kind of decision is up to parent companies.

Where compulsory exclusion is used, the equity method should apply and information must be given under the notes to consolidated accounts.

The accounting law also states that the parent undertaking has the option to exclude a subsidiary from full consolidation when¹²:

- The subsidiary is not material for the purpose of giving a true and fair view; nevertheless, when two or more subsidiaries are material, they must be included in the consolidation;
- Severe long-term restrictions substantially hinder the parent undertaking in the exercise of its rights over the assets and management of the subsidiary; and
- The shares of the subsidiary are temporary held solely with a view to their subsequent resale.

Under Portuguese regulation, there is no option to exclude a subsidiary if the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay.

The POC requires a number of disclosures under the notes about the excluded companies, such as the names, registered offices, the proportion of capital held by the parent company or any person acting on its behalf and a justification for the exclusion but not necessarily the percentage of the voting rights (Note 2).

The Portuguese accounting law does not state the concept of materiality¹³. Therefore, companies have flexibility in using that concept as a reason for exclusion of subsidiaries from full consolidation. As a consequence, the consolidated numbers (*e.g.*, assets, liabilities, and results of operations) may lose significance and override the true and fair view. Moreover, as the companies are not compelled to disclose information under the notes, users of accounting information are limited in their analyses.

The use of the optional exclusions depends upon the judgment of the parent company's managers. The auditors will also judge them in terms of reasonability, by qualifying or not their reports.

2.4. Enforcement mechanisms

European listed groups' adoption of the International Financial Reporting Standards (IFRS) after 2005, which are issued by the International Accounting Standards Board (IASB), makes the question of enforcement a priority. The international harmonization of accounting

¹² Decree-Law 238/91, art 4th.

¹³ The concept of materiality has been detailed in other contexts. This is the case of the Order of Registered Statutory Auditors, which issued a recommendation to its members (*Directriz de Revisão/Auditoria* 320).

standards is the source of this question because, if we want to adopt the same standards all over the world, there must be a mechanism for enforcing the application of these standards.

According to Kothari (2000: 95), "if accounting standards are not enforced vigorously and private avenues of inducing compliance with disclosures standards through shareholder litigation are not easily available, then disclosure quality is likely to suffer."

Our analysis focuses on the statutory auditor's role, as it is crucial in the Portuguese enforcement system. We adopt the perspective of the *Fédération des Experts Comptables Européens's* (FEE) discussion of the European enforcement mechanism. In 1999, FEE published a discussion paper *on Financial Reporting Strategy within Europe*. This study confirms the ambiguity between the existing European enforcement mechanism and the lack of knowledge about the concrete situation in some Member States. Further on, in April 2001, FEE issued another study, which represents a preliminary investigation of the enforcement mechanisms existing in Europe. We based our analysis on the context of this 2001 FEE paper.

According to the FEE (2001: 8), "the enforcement can be defined as all procedure in a country to assure the proper application of accounting principles and standards." Generally, the enforcement is classified in accordance with six different levels: self-enforcement; statutory audit; approval of financial statements; institutional oversight system; court and public and press reactions¹⁴.

The European Commission puts considerable emphasis on enforcement of accounting standards both in the *Financial Services Action Plan* and in the Communication EU *Financial Reporting Strategy: the way forward*. Commission Communication states that "the enforcement comprises a cascade of different elements, including (1) clear accounting standards, (2) timely interpretations and implementation guidance, (3) statutory audit, (4) monitoring by supervisors and (5) effective sanctions."

Also, the SEC in its "Concept Release" on International Accounting Standards, published in

February 2000, stressed that the enforcement cannot be separated from financial reporting. In the introduction of the concept release, SEC noted that the high quality of financial information disclosed by the listed companies does not depend only on the accounting standards. An effective system is needed, which begins with a proper application of the generally accepted accounting standards by company management and which continues with the work of auditors to test and opine about the financial statements.

The United Kingdom has the most efficient European enforcement mechanism of accounting regulation: the Financial Reporting Review Panel (FRRP). This body has been working since 1991 to secure remedial action, when there is no compliance of the Companies Act 1985, and applicable accounting standards (Peasnell *et al* (2000: 5)). The qualified audit report is one of the primary sources that trigger an investigation by the FRRP and the outcome of the work done by this agency is reported publicly when the decision is upheld.

In 2000, the Institute of Chartered Accountants in England and Wales (ICAEW) issued a policy statement (TECH 23-00) that stressed the importance and utility of a uniform enforcement system of international accounting standards across Europe.

Böckem (1998) has analyzed the capital market reaction to accounting standard enforcement activities by the British Financial Reporting Panel (FRRP). Later, in 2000, she has analyzed the possibilities to utilize the capital markets as an enforcement mechanism. She concluded that appropriate enforcement is becoming increasingly urgent considering the existing institutions established in order to enforce accounting standards.

Moreover, Naumann (2000) has studied the financial reporting enforcement mechanisms as an element of corporate governance in Germany. As this author assesses, the recent business crises caused renewed public debate about the work of statutory auditors as an enforcement mechanism and a guarantee of the quality of financial information disclosed by public companies.

¹⁴The European Commission refers to enforcement of accounting standards both in *Financial Services Action Plan* and in the Communication EU *Financial Reporting Strategy: the way forward*. The Commission Communication states that "the enforcement comprises a cascade of different elements, including (1) clear accounting standards; (2) timely interpretations and implementation guidance; (3) statutory audit; (4) monitoring by supervisors and, (5) effective sanctions."

More recently, FEE (2002) has presented a study about the need for improvement or establishment of an effective institutional oversight mechanism for checking the correct application of IFRS in the European context. An enforcement body independent from the reporting enterprise as well as from its auditor and other stakeholders achieves this solution. However, according to FEE (2002: 5), an overall enforcement system comprises both internal and external processes, including external audit and those bodies charged with enforcement by company law and securities legislation. In this study, the FEE focuses on the role and importance of this "enforcement body".

Hope (2002) presents an international study where he analyses the relations between the accuracy of analysts' earnings forecasts and the quantity of annual report disclosure and between forecast accuracy and the degree of accounting standard enforcement. As the author states, there has been little research on enforcement in an international context, which may partially result from the difficulty in measuring enforcement across countries.

As far as we know up to this moment, only one article has been published about the enforcement system in Portuguese and by a Portuguese author (Roberto, 2000). The analysis is theoretical and descriptive and the work is based on the above mentioned 2001 FEE study.

In Portugal, the enforcement mechanism includes various levels. The first is self-enforcement for the preparation of financial statements. The Portuguese company law states that the board of directors must prepare annual financial statements and a director's report. Every member of the board and the official accountant has to sign to assure his agreement. Therefore, the responsibility for those tasks rests with the board members who safeguard the proper application of accounting standards and principles for giving a true and fair view.

The second level of enforcement is the statutory audit. The financial statements and the director's report of Portuguese listed companies must be audited before they are submitted to the supervisory board of the company. Afterwards, these documents have to be audited by a statutory auditor and by an external auditor registered at the CMVM. The general meeting of shareholders approves the accounts. The statutory auditor and the external auditor play an important role

in assuring that accounting standards comply with Portuguese general accepted accounting principles.

The group's auditor must examine the work of the auditors of the undertakings included in the consolidation, as well as audit the individual financial statements of the subsidiaries included in the consolidation when they have not been prepared and audited with similar standards. The aim of this work is to verify the conformity of the financial statements with generally accepted accounting principles and to confirm if the consolidation rules have been adhered to.

The auditor's report consists of four main paragraphs: the first is about the list of documents examined, the amount of total liquid assets, equity and profit/loss; the second regards the company's and the auditors' responsibilities; the third is about the audit's scope and, finally, the fourth is the auditor's opinion. The possible types of opinion are the following:

- *Unqualified opinion*: if the financial statements give a true and fair view;
- *Unqualified opinion with emphasis*: if the financial statements give a true and fair view but there are fundamental uncertainties;
- *Qualified opinion with reserve and without emphasis*: if the financial statements were not prepared according to the generally accepted accounting standards;
- *Qualified opinion with reserve and with emphasis*: if the financial statements were not prepared according to the generally accepted accounting standards.

Concerning the auditing of the consolidated accounts, the OROC has published some auditing standards, namely Technical Recommendation Nr.9 and Technical Interpretation Nr.5. According to these standards, auditors must qualify their report when the companies do not comply with the correct application of the equity method for subsidiaries excluded from the consolidation.

Auditors' independent opinion increases the reliability of the financial statements and, consequently, their role is important in the overall process of enforcement. The Portuguese audit standards are in conformity with the International Standards Auditing (ISA) and the professional association of auditors has a system of quality control based on wide review monitored by a specialized commission. This system of quality increases the enforcement responsibility of statutory audit. In addition, according to CMVM, auditors' work

must be submitted to a quality assurance system in compliance with the recommendation emitted by the European Commission.

Another level of enforcement in the Portuguese system is the approval of financial statements in the general meeting of shareholders. They had the power to approve or not approve the financial statements and the director's report if they do not accord with its preparation and disclosure but they cannot modify that accounting information.

The last level of the Portuguese enforcement system is the oversight system. As noted in the FEE study (2001:10), this level of enforcement of accounting standards in consolidated accounts of listed companies does not exist in all European countries. For the Portuguese listed companies, the Stock Market Authority (CMVM), the Bank of Portugal and the Portuguese Insurance Institute are the main bodies which assure the institutional enforcement system, as courts and public press release have not proved to be important enforcement mechanisms until the present time.

The CMVM enforcement procedure covers both the individual and the group accounts. The powers, which enable the CMVM to perform the supervision activity, are stated in the law. Recognition of non-appropriate appliance of accounting rules may justify that the CMVM imposes sanctions. These sanctions range from penalties to the exclusion of the company from the regulated market.

Auditors may play a key role in the process of guaranteeing the correct application of prevailing standards and thus encompassing the enforcement of the accounting regulations and contributing to the quality of disclosed information. Roberto (2000) states that the auditor is the principal actor in the Portuguese enforcement system and, according to him, the Portuguese enforcement system does not work properly because the capital market does not react to the statutory auditor opinion.

3. EMPIRICAL STUDY

3.1. Sample and data collection

The purpose of this study is to examine the extent

of the use of the clauses for exclusion of subsidiaries from consolidation in order to assess the degree of compliance with accounting regulation and the effectiveness of the statutory auditor as an enforcement mechanisms in case of observed non-compliance.

The sample includes the consolidated financial statements of all the Portuguese companies listed in the Lisbon Stock Exchange on December 31st for the year 1999, to which the Official Accounting Plan is applicable. Accounting practices of those companies and enforcement by the auditors are analyzed on the basis of the consolidated financial statements reported at December 31, 1999.

One of the reasons that justified the selection of this sample is the availability of the accounting information disclosed by these companies. Furthermore, listed companies are subject to an additional audit according to stock market regulation. Thus, public companies have to present an extra auditor's report by a member of the OROC who is registered at the CMVM.

Banks, other financial and insurance companies were excluded from the sample (19 out of 72), because they are subject to specific accounting rules established by their respective supervisory entities, and thus do not follow the POC. Two sports companies were excluded due to lack of information.

Out of the 51 remaining companies, 5 were excluded because they did not publish consolidated accounts. The other three companies were excluded from the sample because we did not receive their consolidated financial statements in due time. A list with the names of the 43 parent companies of groups included in the sample is provided in the Appendix.

Sample data were collected from the financial statements published by groups, mainly in the notes to the consolidated accounts. We asked for the published accounts directly to the companies by telephone, fax or e-mail. The consolidated statements of some companies were downloaded from the Internet¹⁵.

¹⁵ At the moment of writing this article, there did not exist a centralised and available public database of Portuguese accounting information with the necessary information to carry out this type of research. Thus, data were collected directly from financial reports.

Table 1 - The selection of the sample

Number of parent companies	1999	
	Excluded	Selected
Listed at BVL		72
Following the POC	19	53
Sports companies	2	51
Publishing group accounts	5	46
Availability of information	3	43
Final sample		43

The analysis is divided into four parts. The first part focused on key indicators, which characterize the sample and the size of the Portuguese listed groups. The second and third parts discussed the scope of consolidation, subsidiaries included and excluded from the consolidation, the accounting methods adopted and the reasons for it. The fourth part regards the group auditor's report and its role in the enforcement process.

Groups in the sample are classified by industry as shown in Table 2. A significant part of them are in the manufacturing industry or in services to the business sector. On December 31, 1999, 17 out of 43 listed parent companies were holding companies.

Table 2 - Groups in the sample per industry

Industry	1999
Communication	2
Computer activities	2
Construction	4
Entertainment	3
Manufacturing	16
Retail and wholesale	2
Services to the business sector	11
Transport and warehousing	2
Utilities	1
Total	43

Table 3 presents the characteristics of the Portuguese groups in the sample by size. Most of them have total assets, liabilities, equity and turnover between 50,000 and 500,000 thousand Euro.

Table 3 - Groups in the sample by size

(1,000 Euro)	Total			
	Assets	Liabilities	Equity	Turnover
Less than 50,000	2	10	14	9
50,000 – 500,000	24	23	22	25
500,000 – 2,000,000	12	7	5	4
More than 2,000,000	5	3	2	5
Total	43	43	43	43

Table 4 indicates the average number of employees in the groups of companies in the sample. The majority of the Portuguese listed groups employ less than 3,000 persons.

Table 4 - Average number of employees per group

Number of Employees (*)	Groups	
	Number	Per cent
Less than 1,000	16	37
1,000 – 3,000	13	30
3,000 – 6,000	5	12
More than 6,000	9	21
Total	43	100

(*) Including proportionally consolidated associated companies.

3.2. Subsidiaries included in consolidation

Information about the subsidiaries included in the consolidation was collected in the notes to the consolidated accounts. The information that was analyzed referred to the names and addresses of the head offices of the subsidiaries included in the consolidation; the participation in equity held and the reasons for inclusion in the consolidation (Note 1). In some cases, it was necessary to complete this information with disclosures in the individual accounts of the parent company (such as Note 16) and in the group director's report.

All the companies disclosed the names and addresses of the head offices of the subsidiaries included in the consolidation. However, some groups did not provide any information about the percentage of equity capital held and the percentage of control (number of voting rights), the latter being a necessary condition to decide upon the obligation to consolidate. Table 5 summarizes these disclosures.

Twenty-one groups (49 per cent of total) disclosed the minimum required information regarding the type of information, but we did not observe any case of voluntary disclosure.

We found some diversity in the format and wording used for presenting the percentage of equity capital held. Within the 8 groups listed in Table 5, under the item *percentage of equity capital held, without specification*, we observed that the majority referred to direct participation.

Table 5 - Information about participation and control

Type of information disclosed	Groups	
	Number	Per cent
Effective percentage of equity capital and percentage of control	21	49
Direct and indirect percentage of equity capital held	11	25
Percentage of equity capital held, without specification	8	19
Percentage of control held	3	7
Total	43	100

Some groups disclosed only percentages of directly held capital while others also provide information about indirect percentages of participation. It is our opinion that disclosure of both direct and indirect participation would be useful information for the users of the group accounts because the accounting concept of control depends either on one or both types of participation.

We must remark that 65 per cent of the groups in the sample hold own shares or own parts, but we did not find any information about the owner of these shares, either the parent company or any of its subsidiaries in the notes¹⁶. This information is important because own shares in affiliated companies must be deducted when computing the

number of voting rights to establish the percentage of control, which is necessary to assess the obligation to consolidate. Additionally, own shares are important for the calculation and subsequent inclusion of the minority rights in the consolidated balance sheet.

Portuguese groups should include in the scope of consolidation the subsidiaries according to at least one of the conditions mentioned in Table 6, which are in accordance to the law¹⁷.

Table 6 - Concept of group adopted by listed companies

Type of control	Groups	
	Number	Per cent
Majority of voting rights	37	86
Appointment or removal of majority of board members	1	2
Exercise of dominant influence	3	7
Power to appoint the members of the board of directors with ownership of at least 20 per cent of voting rights	2	5
Control by contract	2	5
No information disclosed	4	9

We observed that 37 out of 43 (86 per cent) of the Portuguese listed parent companies presented group accounts based on the majority of voting rights directly or indirectly held. Consequently, we conclude that the *de jure* control was the most used criteria to consolidate.

Five listed groups, which are among the largest ones, made use of more than one type of control when deciding about the inclusion of subsidiaries in the scope of consolidation.

Four groups did not disclose any information about the clauses for inclusion, leaving the user with less than the minimum required information disclosure.

However, the auditors did not issue qualified opinions in their reports regarding this topic.

3.3. Compulsory and optional exclusions from the consolidation

The Portuguese accounting regulation, as described in Section 2, includes compulsory and optional exclusions of subsidiaries from consolidation. The POC states that parent companies should disclose information about the subsidiaries excluded from the consolidation in the notes to the consolidated financial statements (Note 2).

¹⁶ Information about own shares disclosed in the manager's reports is not sufficient for consolidation purposes, namely in what concerns the scope of consolidation.

¹⁷ Decree-Law 238/91, art 1st, Nr. 1.

Table 7 summarizes the type of information disclosed by Portuguese listed groups about excluded companies.

Table 7 - Disclosures about excluded subsidiaries

Type of information disclosed	Groups	
	Number	Per cent
Percentage of equity		
Only direct percentage of equity held	19	56
Only indirect percentage of equity held	2	6
Both direct and indirect percentage of equity held	11	32
Reasons for the exclusion	33	97
Accounting methods	31	91

The majority of companies provided information about the percentage of participation held in the equity of the subsidiaries excluded, the reasons for the exclusion and the accounting methods adopted in the valuation of the excluded undertakings.

Only three groups in the sample reported to have excluded subsidiaries according to the compulsory condition, that is, based on differences of activity between the parent company and itself. These three subsidiaries were evaluated according to the equity method in accordance with the Portuguese accounting regulation. We can conclude that, with respect to this issue, the makers of the Portuguese group accounts complied with the objective of giving a true and fair view of the group.

One company¹⁸ exclusively reported to have excluded subsidiaries and indicated to have registered their participation in the excluded subsidiary at the cost of acquisition, but nothing else. This is obviously a case of insufficient disclosure; as the minimum required information includes the disclosure of the reasons for the

exclusion. We remark that the auditors have not qualified their reports regarding this omission of disclosure.

Finally, we observe that nine listed parent companies did not disclose any information about exclusions. We do not know if this is due to the fact that they did not exclude any company from consolidation or simply because they follow the general practice observed in financial reporting of Portuguese companies not to mention the notes to the accounts where they do not apply.

The optional exclusions depend upon the judgment of the managers of the parent company and the auditors will also judge them in terms of reasonability. Although the majority of companies in the sample refer to have made use of one or more clauses of optional exclusion, they do not provide details about this issue, thus disclosing less than the minimum information required by Portuguese accounting regulation. The frequency of use of these optional clauses for exclusion is summarized in Table 8.

Table 8 - Reasons for the optional exclusion of subsidiaries

Type of reason	Groups	
	Number	Per cent
Non-materiality	27	63
Temporary holding	6	14
Severe long term restrictions to exercise control	5	12
Other	12	28

Non-materiality is the most common reason that groups have used to justify the non-consolidation of subsidiaries (27 out of the 43 groups in the sample or 63 per cent). The Portuguese accounting regulation does not provide a definition of materiality. In most cases, the consolidated figures can be significantly

influenced by the different interpretation given by the makers of the accounting information to "materiality" in each particular case. So, one is forced to admit that the disclosure requirements about materiality have been implemented quite diversely in the practice of the Portuguese groups.

¹⁸ *Fábrica de Porcelana da Vista Alegre, S.A.*

Exclusions based on *severe long-term restrictions* refer to subsidiaries located in foreign countries over which the parent company is limited in its possibility of exercising control. There are either restricted policies on behalf of local governments or difficulties in transferring funds. This happened with the Portuguese companies with subsidiaries in the former Portuguese territories in Africa. Additionally, we observed one parent company that excluded a subsidiary due to an ongoing legal process.

Concerning the exclusion of subsidiaries based on non-materiality, only one company out of the 27 observed cases had its auditor's report with a qualified opinion. We may conclude that auditors of the

remaining 26 groups judged that the actual concept of materiality adopted by those companies do not affect the true and fair view of the consolidated accounts. This judgment was certainly supported by the technical standards and interpretations issued by the OROC, which the auditors must follow when performing their work. In fact, this professional body issued a specific auditing standard about the materiality concept.

We noticed that 12 groups decided to exclude subsidiaries based on *other reasons*, not expressly stated in the accounting regulation. Table 9 details the other reasons mentioned as clauses of optional exclusions.

Table 9 - "Other" reasons for optional exclusions of subsidiaries

Type of reasons	Groups	
	Number	Per cent
Subsidiary without activity	8	67
Subsidiary recently forming part of the group	1	8
Non availability of information about the subsidiary	1	8
Non specified reason	2	17
Total	12	100

The majority of the optional exclusions justified by *other reasons* are cases of subsidiaries without activity (8 groups). This fact may be explained by the Portuguese tax regulation. According to fiscal law subsidiaries without activity¹⁹ must be excluded from the fiscal consolidation. We noted that two groups did not specify the reasons for the exclusion.

Regarding the methods used in the valuation of the subsidiaries excluded according to optional reasons, we must point out that this kind of information does not appear systematically under the due notes to the accounts. While some companies disclosed this type of information under Note 2, others used Note 23 (addressed to specifically inform about measurement methods), or even Note 0 as an introduction to the usual notes. This fact increased our difficulties in analyzing

the data and will certainly not benefit investors and others interested parties' use of the consolidated information.

Most of the parent companies of Portuguese listed groups did not use the equity method to account for the subsidiaries excluded from consolidation according to optional reasons. Instead, the cost of acquisition has mostly been applied.

As shown in Table 10, 23 companies have recognized their investments in subsidiaries on the basis of the acquisition cost. We observed that the auditors, in their reports about the individual accounts, paid attention to the fact that participations were evaluated at acquisition cost and not according to the equity method. This was one of the most frequent qualifications in the individual audit reports but not in the consolidated reports.

¹⁹ According to Ministério das Finanças (1994).

Table 10 - Valuation methods for excluded subsidiaries

Valuation methods	Groups	
	Number	Per cent
Cost of acquisition	23	68
Equity method (*)	6	17
Cost of acquisition and equity method	2	6
Non disclosure of the method	3	9
Total	34	100

(*) Out of six reported groups, three are the subsidiaries excluded for a compulsory reason.

In addition, there are three cases of non-disclosure of the valuation method for the excluded subsidiaries. Once again the auditors did not refer to this practice in their reports.

3.4. Enforcement by the auditors

The consolidated accounts of the Portuguese listed companies are subject to two audit reports: the legal certification of accounts and the external auditor's report. These two levels of enforcement are an interesting aspect of auditing in Portugal, but the discussion of differences between them is beyond the scope of this article.

The consolidated financial statements and the consolidated director's report must be audited before they are submitted to the supervision board of the parent company. The aim of the group auditor's work is to verify the conformity of the financial statements with the generally accepted accounting principles and to confirm if the consolidation rules have been adhered to.

For 1999, we notice that 5 out of the 43 Portuguese listed groups did not publish the external auditor's report and, additionally, one of them also did not

publish the legal certification of accounts. Thus, we analyzed 42 groups' statutory auditor's reports and 38 reports issued by the external auditors of the Portuguese listed groups.

Although it is already possible for a Portuguese company or group to have a legal certification of accounts by a EU auditor, the official group auditor (ROC) of every Portuguese listed group, which published its 1999 auditor's report, has been a national auditor or a domestic firm. However, a number of Portuguese-based groups have increasingly been using the services provided by the big international auditing firms to carry out voluntary independent audit in accordance with international auditing standards. Sometimes, the person who acts as the official auditor of the company or the group is also a partner or a senior manager of a multinational-auditing firm.

The majority of Portuguese listed groups have their audit reports qualified. We observe that 21/42 and 20/38 reports present a qualified opinion. However, most of the qualifications do not address accounting consolidation issues. Table 11 summarizes the type of opinion (reserves and emphasis) found in the 1999 audit reports of the Portuguese listed groups.

Table 11 - Opinion in the auditor's reports of Portuguese listed groups

Type of Opinion	Legal Certification of Accounts Companies		External Auditors Report Companies	
	Number	Per cent	Number	Per cent
Without reserve and emphasis	11	26	10	26
Without reserve but with emphasis	10	24	8	21
With reserve but without emphasis	4	10	4	11
With reserve and with emphasis	17	40	16	42
Total	42	100	38	100

NOTE: One company did not publish the Legal Certification of Accounts and 5 companies did not publish the External Auditor's Report.

The differences observed between opinions expressed in one type of auditing report and the other result from the cases where external audit and statutory audit reports are not disclosed.

We observed that in about half of the Portuguese listed groups (20 groups) the auditor who was responsible for the legal certification of the consolidated accounts and the external auditor of

the group (who issued the external auditor report of the group) are not the same person. Nevertheless, the opinions they have expressed in both documents coincide.

Table 12 details the contents of the nine

qualifications made by the auditors, both in the legal certification of accounts and in the subsidiaries external auditor's reports. These qualifications regard the scope of consolidation, exclusion from consolidation and their valuation of group accounts.

Table 12 – List of reserves in the auditor's reports of listed groups

Reserves about the scope of consolidation

- Exclusion of a subsidiary based on the non availability of its financial information and its valuation at the acquisition cost
- Non updated financial information about the investments carried out in undertakings located in African countries

Reserves about the valuation methods of consolidation

- Financial participation in a subsidiary held 100 per cent registered at the acquisition cost
- Subsidiaries registered at acquisition cost
- Non-adoption of the equity method
- Criteria adopted in the valuation of shares following a merger

Reserves about principles and procedures adopted in the consolidation

- Financial investments not recoverable
- Deduction of the consolidation differences directly from the equity capital
- Lack of uniformity when applying the equity method

Four emphases were expressed by the official auditors of the Portuguese listed groups in their reports referring to the 1999 consolidated accounts. These qualifications concerned the following issues:

- Inclusion of geographically dispersed subsidiaries in the consolidation which were not subject to the audit;
- Increase of the nominal capital in one subsidiary with the emission of preferred stock;
- Eventual loss of value of the financial investments without provision, and
- Ongoing legal process related to an excluded subsidiary.

We observe that when the group did not adopt the equity method for the valuation of the subsidiaries, which were not fully consolidated due to exclusion based on the optional clauses of exclusion, in some cases, the auditors did not qualify their reports. This lack of uniformity in the audit reports can be explained by the ambiguity in Portuguese accounting regulation in individual accounts *versus* consolidated accounts regarding the extent of the use of the equity method in valuing excluded subsidiaries. In fact, it is clear that the use of the equity method in the consolidated accounts is compulsory for the valuation of the

subsidiaries not included in the consolidation based on different activities. However, its use in case of optional exclusions of subsidiaries is more doubtful.

Regarding the individual accounts, while the POC allows either the adoption of the equity method or the valuation at the cost of acquisition, an accounting standard issued by the CNC (*Directriz contabilística* Nr. 9), recommends the former to be used in the individual accounts for the valuation of both subsidiaries and associated companies.

Furthermore, the statutory auditors have to apply the auditing standards issued by their professional body, the OROC, when preparing the auditing reports. In a technical recommendation (*Recomendação técnica* Nr.9), the OROC states that the subsidiaries excluded from the consolidation must be valued at the equity method, unless a reasonable justification is provided under the notes to the consolidated accounts²⁰.

According to these results, we may expect that the quality and the quantity of accounting information disclosed by the Portuguese listed groups about the adopted concept of group, subsidiaries included and exclusions from consolidation, as well as consolidation procedures in general will help to move towards a true

²⁰The OROC also issued a technical interpretation (*Interpretação técnica* Nr. 5) concerning the use of the equity method in the valuation of subsidiaries and associated companies in the individual accounts. According to this standard, the auditor should include an emphasis in his or her report when the equity method is not applied or if the reasons for not having used the said method are not disclosed in the notes to the individual accounts.

and fair view in group financial reporting.

Regarding the role of the auditor as an actor of enforcement of the accounting regulation, the results of this study compel us to agree with the statement by Needles *et al* (2001: 19) that the next step in the improvement of financial reporting is to improve the quality of individual audits that take place around the world through government regulation, self-regulation of the profession and quality assurance in international firms. We are tempted to say that the users of group accounting information would benefit if auditors would become more active as enforcement actors of the Portuguese accounting regulation.

In our opinion, this will allow for a better understanding of the reasons for the observed group accounting practices adopted by the Portuguese listed groups and their group financial reporting. This type of research would benefit from interviewing the auditors, which would allow for some insight into their attitudes and behavior during the process of issuing their audit reports and the way in which they interrelate with the developers of group accounts.

4. CONCLUSION

The main conclusions to be reached from this analysis about the concept of group and the exclusions of subsidiaries from consolidation, carried out with the consolidated financial statements of non financial companies listed in the Lisbon Stock Exchange and reported for the end of 1999 are the following:

- In general, the information published by the Portuguese listed groups complies with the minimum disclosure requirements;
- The most commonly used criterion for consolidation is the majority of voting rights;
- Few groups adopted the compulsory clause for the exclusion of subsidiaries from consolidation;

- Optional exclusions of subsidiaries were mainly justified by non materiality and depend on the accountants' judgment and reasonability;
- The equity method was always used to evaluate subsidiaries compulsorily excluded from consolidation;
- The auditor's opinion scarcely referred to topics related to the exclusion of companies from the consolidation;
- In few cases, the auditors did not qualify their reports; nevertheless, the disclosures made by Portuguese groups were less than the minimum required.

The reported results suggest that the auditor's role as an enforcement mechanism in the financial reporting of Portuguese listed groups has been weak and may be improved.

Availability of data from Portuguese group accounts, which is necessary to carry out empirical studies on Portuguese group accounting, remains a problem and this is the reason why we were compelled to restrict our study to 1999. Extending the analysis to other years would certainly contribute to a better understanding of accounting practices and the politics of enforcement of Portuguese accounting regulation.

Our findings suggest that, in order to improve the comprehension of accounting practices adopted by Portuguese groups, future research should emphasize the analysis of other items reported in consolidated financial statements, such as measurement methods, own shares and non-voting rights. In particular, a closer look at the concept of group and how the managers structure the entity to be consolidated would be useful because, in general terms, there is a lot of regulatory support for requiring consolidated disclosure but there is less consensus about which method of reporting is the most appropriate.

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APPENDIX - NAMES OF THE PARENT COMPANIES INCLUDED IN THE SAMPLE

- | | |
|---|---------------------------------|
| 1. Barbosa & Almeida | 23. Lisgráfica |
| 2. Companhia de Celulose do Caima | 24. Lusomundo |
| 3. Centralcer | 25. Modelo Continente |
| 4. Cimpor | 26. Mota & Companhia |
| 5. Cin | 27. Mundicenter |
| 6. Cires | 28. Orey Antunes |
| 7. Cofina | 29. Papelaria Fernandes |
| 8. Colep | 30. Pararede |
| 9. Compta | 31. Portucel |
| 10. Corticeira Amorim | 32. Portugal Telecom |
| 11. EDP - Electricidade de Portugal | 33. Portugal Telecom Multimédia |
| 12. Efacec | 34. Reditus |
| 13. Engil | 35. Salvador Caetano |
| 14. Espart | 36. Soares da Costa |
| 15. Estoril Sol | 37. Somague |
| 16. F. Ramada | 38. Sonae Indústria |
| 17. Fábrica de Porcelana Vista Alegre | 39. Sonae Holding |
| 18. Imobiliária Grão Pará | 40. Soporcel |
| 19. Ibersol | 41. Sumolis |
| 20. Inapa | 42. Teixeira e Duarte |
| 21. Investimentos Turísticos na Ilha da Madeira | 43. Tertir |
| 22. Jerônimo Martins | |