



The Future of Financial Statements Audit

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Abstract

In countries without a longstanding tradition of audit, the view is that developing a capacity in audit is essential for underpinning and enhancing economic growth. The financial statement audit is seen as a gateway to a stronger accountancy profession and, with it, greater prosperity. By contrast, in countries where audit is more established, the view is that audit itself must develop. The suggestion is that new, differentiated types of reporting and new assurance offerings will keep the financial statement audit relevant for users. Auditors will need to keep their skills up to date to respond to the challenges created by heightened expectations of the profession. The digital age creates opportunities and threats. This paper sets out some recommendations for standard setters and regulators to support better global outcomes.

Keywords: financial statements; financial audit; future of audit; auditing standards.

1. Introduction

In countries where audit is less developed, the view is clear: audit is an enabler of growth. It underpins market confidence, reduces the cost of capital and transaction costs, boosts capital flows and serves as a cornerstone for the business environment. The feedback from the roundtables is that audit is absolutely vital for engendering trust in business.

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As a result, building capability in audit is a key priority for countries seeking sustainable economic growth. In such countries, the audit is a comparatively recent offer, with providers of finance primarily interested in financial information about a company and little else. There is currently limited interest in other assurance services to complement the audit, let alone alternative assurance offerings that might replace it. These countries see the future of audit as being about building consistent quality and making the audit process more efficient for companies, users and auditors. The audit might be increasing in popularity, or demand for audit might outstrip supply. Alternatively, the auditing profession might be relatively small, making use of expertise from other countries, or be in the early stages of moving from national to international standards. The quality of audits might be inconsistent, or there might be relatively few firms capable of auditing banks, utilities or the public sector. In developed markets, audit has typically been mandatory for a long period. In such countries, there may have been moves to exempt businesses of certain types or sizes from the audit requirement. Companies may have more skilled finance teams, producing more trustworthy financial information than those in developing countries. Providers of finance may receive regular, reliable financial updates as a matter of course, so that for them the annual audit report is seen as ‘old news’ and merely confirmatory. Additionally, they may receive a regular, rich and varied range of information about the business, which is essential for investment decisions but is not financial and not part of the audit. In these developed countries, audit is seen as a critical bedrock for larger companies, but with little additional value other than confirmation of what is already understood about a business. For companies that are neither large nor publicly traded, significant questions are being asked about whether the audit report is useful[1]. Another key driver for change is legislative and regulatory intervention. For example, in the European Union, legislators are requiring auditors to do more, beyond the traditional scope of the historical financial statement audit, for listed company audits. Once these additional services have been streamlined, demand for them may grow elsewhere in the world, and beyond the listed company sector.

2. The importance of financial statements for the company

The statements that are prepared at the end of a particular accounting period to measure the overall result of business activities and exhibit the financial position of a business concern are generally called financial statements. Financial statements are the principal means through which financial information is communicated to those outside an enterprise. These statements provide the firm’s history quantified in money terms.

The financial statements most frequently provided are:

- the balance sheet,
- the income statement,
- the statement of cash flow, and
- the statement of owner’s or stockholder’s equity. Also, note disclosures are an integral part of each financial statement.

Through financial statements, necessary information is communicated to various interested parties. Financial statements play a role in providing information. Financial statements are considered as the mirror of a business concern because they reflect the working capacity or weakness of a business concern. Financial statements come

to the use of various parties. For example, management, investors, banks, creditors, officials, government, business organizations, consumers and general masses are benefited by financial statements.

3. Types of financial statements

Financial statements are mainly four statements and generally prepared by most of the business concerns. These are;

- Income statement
- Owner's equity statement
- Balance sheet.
- Statement of cash flow.

3.1 Income statement

The statement which is prepared at the end of a particular accounting period with the help of periodic income and expenditure to know the operating result i.e. profit or loss of a company is called an income statement. The main source of income of a business concern is sales and for the profiteering service-oriented organization is the income received from service rendered. Besides these, other incomes are interest received on investment, profit or sale of assets, etc. Expenditures mean merchandise purchase of a particular period and operating expenses of a particular period such as administrative expenses, selling and distribution expenses and other expenses.

3.2 Owner's equity statement

The statement which is prepared to show changes of owner's equity for a particular period is called the owner's equity statement. In this statement profit of a particular period is added with the beginning capital of that period and loss if any, drawings are deducted for ascertaining the ending capital of that particular period.

3.3 Balance sheet

A balance sheet is prepared at a particular date to know the financial position of a company of that particular date. The ledger account balances that remain after the preparation of income statements are assets, liabilities, and capital. The statement which is prepared on the end day of an accounting period with assets, liabilities and owner's equity is called a balance sheet. The balance sheet is called the statement of financial position.

3.4 Cash flow statement

In the present day, the cash flow statement is considered as an important part of financial statements. Incorporate business organizations, preparation of cash flow statement is mandatory. The statement, which is prepared to show cash inflow and cash outflow for a particular period, is called the cash flow statement.

4. Elements of financial statements

- **Asset:** Assets are the resource owned by a business. For example; Cash, Land, furniture, and equipment.
- **Drawing:** Drawing is the withdrawal of cash or other assets from a business for the personal use of the owner. For example- Cash drawing. Goods drawing.
- **Liability:** Liability is the creditorship claim on total assets. For Example- Accounts payable, Salary payable and Rent payable.
- **Owner's Equity:** owner's Equity is the ownership claim on total assets. For example- Capital, Additional Investment.
- **Owner's Equity Statement:** Owner's Equity Statement summarizes the changes in owner's equity for a specific period.
- **Shareholder's Equity:** The owners' interest in a corporation is called shareholder's equity.
- **Accounts Receivable:** Account Receivables are amounts due from customers for goods or services sold on credit services already provided, Accounts Receivables are oral promises of the purchases to pay for goods and services sold.
- **Accounts Payable:** Amounts owed to customers for goods or services purchased on credit.
- **Cash Flows Statement:** A Cash flows statement provides information about the cash inflows and outflows for a specific period.
- **Income (Earning) statement:** Financial statement that shows the revenues and expenses and reports the profitability of a business organization for a stated time.
- **Revenues:** Revenues are the inflows of assets resulting from the sale of products or the rendering of services to customers.
- **Retained Earnings:** Retained earning equal to the accumulated net income fewer dividend distributions to shareholders.
- **Expenses:** Expenses are the cost incurred to produce revenues measured by the assets surrendered or consumed in serving customers.

5. Users of financial statements

5.1 Management

The owner or management can know the results and true financial position of a business from financial statements. With the help of the statements, it becomes easier to decide on the expansion or contraction of business as per necessity[2]. For example, if the ratio of return on investment is comparatively high, the management is inspired to invest more. On the other hand, if the business incurs a loss, management may decide to contract the business or to close it down. That is, management can take proper and timely decisions determining the success or failure of a business with the help of financial statements. Total assets of the business, total outstanding credits and debts are available in financial statements.

5.2 Investors

Investment is of both long term and short term. A conscious investor invests in business after proper consideration of its debts, assets, profit-earning capacity, etc. The investor takes into consideration the paying capacity of interest and the security of his investment. An investor can analyze long, term financial capacity of concern from financial statements. Besides current analysis and interpretation, the investor analyses the future financial position with the help of financial statements.

5.3 Creditors

A business is to repay the creditors within the short-term. This debt is paid out of current assets. Therefore, the creditors are interested to know the position of current assets. Financial solvency of a business concern can be ascertained with the help of the current ratio and acid test ratio prepared with current assets and current liabilities mentioned in the balance sheet.

5.4 Bankers

The bank always considers the security of the loan given to the business concern. It also studies the financial capacity of the business concern regarding regular payment of interest on the loan. Bank interprets the balance sheet of a business concern to know the financial solvency and debt-paying capacity of a business. It also studies the revenue earning capacity of the business.

5.5 Government

Financial statements are important to the government for various purposes. The government can be aware of income tax, VAT, sale tax, duties, etc. payable to the government by business concerns from financial statements[3]. Besides, in formulating trade policy, taxation rules, industrial policy, etc. of a country financial statements of business concerns play an important role. Government analyses the financial position of the country from financial statements of business concerns. These financial statements are the proofs of compliance with the government rules in running the business.

5.6 Employees

Employees' interests are directly related to financial progress and regress of the business concern. Employees always remain eager to know the true financial position of a business concern and this can be known from financial statements.

5.7 People

Mass people are also benefited from the financial statements of business concerns. Flourishment of business leads a country to the path of development by increasing investment. As a result employment opportunities increase, regular supply of good at reasonable rates is ensured. This helps social development increase the standard of living of the mass people. From the above discussion, it can be said that the financial statements of concern mean a consolidated position of some matters.

For example: a statement of asset and liabilities prepared at the end day of the year, an income statement determining results of business activities of a particular period, cash flow and fund flow statements showing the reasons of changes of cash and funds, statement of owner's or stockholder's equity and notes to accounts and disclosure.

6. Need for financial statement audits

A financial statement audit is the examination of an entity's financial statements and accompanying disclosures by an independent auditor, with the result being a report by the auditor, attesting to the fairness of presentation of the financial statements and related disclosures[4]. Similarly, lenders typically require an audit of the financial statements of any entity to which they lend funds. Suppliers may also require audited financial statements before they will be willing to extend trade credit (though usually only when the amount of requested credit is substantial). Audits have become increasingly common as the complexity of the two primary accounting frameworks, Generally Accepted Accounting Principles and International Financial Reporting Standards, have increased, and because there has been an ongoing series of disclosures of fraudulent reporting by major companies[5]. The need for independent audits of financial statements can be attributed to four conditions as follows:

6.1 Conflict of Interest

Many users of financial statements are concerned about an actual or potential conflict of interest between themselves and the management of the reporting entity. This apprehension extends to a fear that the financial statements and accompanying data prepared by management may be intentionally biased in management's favor. Thus, users seek assurance from outside independent auditors that the information is both:

- free from management bias, and
- neutral concerning the various user groups.

6.2 Consequence

Published financial statements are the only source of information for users in making significant investments, lending and other decisions. So statement users look to the independent auditor for assurance that the financial statements have been prepared in conformity with GAAP, including all the appropriate disclosures.

6.3 Complexity

As the level of complexity of accounting increases, so does the risk of misinterpretations and unintentional errors. So to evaluate the quality of the financial statements, users rely on independent auditors.

6.4 Remoteness

Distance, time and cost make it impractical even for the most knowledgeable users of financial statements to

seek direct access to the underlying accounting records to perform their verifications of the financial statement assertions. So users rely on the independent auditor's report to meet their needs.

7. Planning an audit of financial statements

Planning often begins shortly after, or in connection with, the completion of the previous audit, for example, with a review of issues that were discussed with management, such as control deficiencies or unadjusted errors. Such matters are relevant to the next year's audit and need to be considered when planning[6]. Similarly, the audit plan may be revised as the audit progresses, and should not be viewed as being fixed in place once the main planning phase has ended. For example, a significant event may take place as the audit is in progress, meaning that the audit plan needs to be changed. The nature and extent of planning activities depends on the size and complexity of the audit client, previous experience of the audit firm with the client, and any changes in circumstance that may occur during the audit. Effective planning will focus the auditor's attention on key areas of the audit and ensure that sufficient resources are allocated to the engagement. Planning should result in an audit that is well directed and supervised and ultimately good planning will reduce audit risk[7].

7.1 Audit strategy

The audit strategy sets out in general terms how the audit is to be conducted and sets the scope, timing and direction of the audit. The audit strategy then guides the development of the audit plan, which contains the detailed responses to the auditor's risk assessment. An underpinning principle of audit planning under the Clarified ISAs is that the audit plan should contain detailed responses to the specific risks identified from obtaining an understanding of the audited entity. ISA 300 requires the auditor to consider specific matters when establishing the audit strategy, and provides a list of typical matters to be considered in its appendix[8].

7.2 Audit plan

ISA 300 states that once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking in to account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other[9]. Therefore it is not necessarily the case that the audit strategy is prepared and completed before the audit plan is devised, and in practice it is typical for the two to be developed together. The audit plan is a detailed programme giving instructions as to how each area of the audit will be conducted. In other words, the audit plan details the specific procedures to be carried out to implement the strategy and complete the audit[10].

7.3 Documentation

ISA 300 requires that as well as the audit strategy and audit plan being thoroughly documented, a record of significant changes made to the audit strategy and audit plan is needed. Documentation is crucial, because key decisions about how the audit will be performed are contained in the audit strategy and audit plan. The

documentation should therefore include the response made by the auditor to any significant changes that occur during the audit, as discussed above. The audit strategy and audit plan do not need to be documented in a particular way. Some audit firms use memoranda, others checklists. Some use standardised documentation such as standardised audit programmes while others tailor the specific form of the documentation to each audit engagement. The form of the documentation does not matter as long as it provides a clear record of how the audit was planned[11].

7.4 Direction, supervision and review

ISA 300 requires that the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. It is crucial that the audit plan includes the detail as to how supervision and review should be conducted during the audit, in order to perform a high quality audit. Inadequate supervision and review can lead to the audit team making errors, for example, selecting inappropriate items for sampling, or failing to properly conclude on audit procedures performed. The amount of detail included in the audit plan in relation to supervision and review will depend on factors such as the size and complexity of the entity being audited, the assessed risk of material misstatement, and the capabilities and competence of the audit team members.

8. Limitations of financial statements audit

A financial statement audit made by GAAS is subject to several inherent limitations. One constraint is that the auditor works within fairly 'restrictive economic limits. To be useful, the audit must be at a reasonable cost and within a reasonable length of time. The limitation on cost results in selective testing, or sampling, of the accounting records supporting data. The time constraint may affect the amount of evidence that can be obtained concerning events and transactions after the balance sheet date that may affect the financial statements. Another significant limitation is the established accounting framework for the preparation of financial statements. Alternative principles are often permitted under GAAP, estimates are an inherent part of the accounting process, and no one including auditors can foresee the outcome of uncertainties. Despite these limitations, a financial statement audit adds credibility to the financial statements.

9. Conclusion

Planning an audit involves more than just obtaining business understanding and performing risk assessment. Planning is a dynamic process that may evolve during the audit, and should always respond to changes in the circumstances of the audited entity. Adherence to the requirements of International Standards of Auditing should result in a well-focused audit, staffed by appropriate personnel, performing relevant and appropriate audit procedures. For countries that are developing their audit capability, a stable body of standards fosters understanding and improvement in audit quality. For countries with a mature audit sector, there is an argument that only marginal gains in the usefulness of an audit are available, which may be out of proportion to the effort required to make those gains. While consistency of standards is important for international business, the implication for standard setters is that they need to articulate the business benefit of changes. International

standard setters should also recognise that different countries are on different stages of audit development, and should seek to reflect that in standards that are designed to be suitable for entities of all sizes. Marginal gains in audit quality may not be worth the additional effort required to capture them, so standard setters and regulators need to articulate the business benefit of changes. Regulators should recognise the balance between audit quality, consistency and innovation, by giving audit firms the flexibility to apply auditing and quality control standards in new ways, provided that audit quality is maintained or improved.

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