Applying the Category of «Assertions (or Preconditions)» In Audit of Financial Statement

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Abstract

The article considers the problems of applying the category of financial statement assertions (or preconditions) during the audit of financial statement. It is suggested to apply the financial statement assertions to assess the audit risk' components, test of controls, planning an audit. The purpose of this paper is to present the significance of financial statement assertions in audit practice. In ISA and the Russian standards on audit different aspects of applying preconditions of financial statement by the auditor at all audit stages are presented.

Keywords: *financial statement assertions, audit risk, International standards on auditing (ISA), financial reporting framework, the preconditions of financial statement.*

1. Introduction

Researching the category of "financial statement assertions" (or "the preconditions of financial statement") is extremely actual for the developing of audit methodology, in scientific literature the necessity of formulation the whole concept of the preconditions of financial statement is designated. These preconditions are indirectly mentioned as criteria according to which the assessment of auditor evidence is carried out. In 2003 year commenting on Federal standard on auditing No. 5 "Audit evidence" N. A. Remizov emphasized that "… almost all ISA is based on the concept of preconditions of financial statement. Fundamental concepts of materiality, auditor risks, preparation of audit programs (without speaking about audit evidence as those) are based on this concept" [1, p.138].

According to ISA "assertions" means representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that my occur.

According to the Order of the Russian Federation Ministry of Finance of 16.08.2011 No. 99n is approved the Federal Standard on Audit (FSA) № 7/2011 "Audit evidence" according to which preconditions of financial statement are assertions in an obvious or implicit form by entity's management concerning recognition, an assessment and disclosure in financial reports. According to this standard as a part of financial statement assertions are presented: completeness, occurrence, accuracy, the rights and obligations, classification, valuation, existence, reference by the period, clearness [2, p.227].

2. Theory

The contextual analysis using the concept of "financial statement assertions" ("preconditions of financial statement preparation"), implemented by Vasilenko A.A. showed that the preconditions of financial statement are connected first of all with risk of material misstatement (38 mentions), audit evidence (37 mentions), audit procedures (28 mentions) [3, p.35].

Auditors are obliged to assess risks of material misstatement at two levels. First, at the level of financial statement as a whole. It concerns risks of material misstatement which are mentioning financial statements as a whole and potentially affect many assertions. The second level is related to the risks identified with specific assertions at the class of transactions, account balance, or disclosure level. It means that for each account balance, a class of transactions and disclosure, the risk assessment (such as high, moderate, or low) has to be made according to each separate assertion.

Generalization of points ISA 315 "Identifying and assessing the risks of material misstatement through understanding the entity and its environment" about the preconditions of financial statement confirming appropriate categories of financial information is given in table 1.

Table 1. The link between financial statement assertions and confirmed categories of financial information

Categories of financial information	Financial statement assertions which confirmed categories	Description
Classes of transactions and events for the period under audit	Occurrence	Transactions and events that have been recorded have occurred and pertain to the entity
	Completeness	All transactions and events that should have been recorded have been recorded.
	Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately
	Cutoff	Transactions and events have been recorded in the correct accounting period
	Classification	Transactions and events have been recorded in the proper accounts
Account balances at the period end	Existence	Assets, liabilities, and equity interests exist
	Rights and obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity
	Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded.
	Valuation and allocation	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
Presentation and disclosure	Occurrence and rights and obligations	Disclosed events, transactions, and other matters have occurred and pertain to the entity
	Completeness	All disclosures that should have been included in the financial statements have been included
	Classification and understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed.
	Accuracy and valuation	Financial and other information are disclosed fairly and at appropriate amounts

The importance of assertions is traced in definition of the audit risk components presented in ISA and Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities.

The inherent risk is a susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls [4, p.32].

For example, if the subject has the high cost inventories which could be easily stolen, there will be an inherent risk concerning the assertion about existence. This assessment of risk ignores an installed system of internal control for protection of such inventories.

Responding actions to an inherent risk are undertaken both at the level of financial statements, and at the level of assertions.

Control risk - risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

It belongs to the risk of that the entity's controls (are developed to reduce any concrete risk) won't be able to work properly, leading to misstatement. Thus the entity's management has to identify and estimate the enterprise and other risks (such as fraud) and to make response it by organization and introduction of internal control system. Entity's controls of a certain level, such as supervision from board, the general controls in information technologies, and management policy of human resource extend on all assertions whereas controls of activity on a certain level usually concern certain assertions.

Detection risk means risk of that the auditor will not detect a misstatement which exists in the assertion and that could be material, either individually or when aggregated with other misstatements.

The acceptable level of detection risk for this level of audit risk is inversely proportional to the risks of material misstatements at the level of assertions.

3. Results

For identification and assessment of audit risk components it is offered to be guided by financial statement assertions that can be reflected in a working paper such form (table 2) [5].

Table 2. The register of risks

№	The risk factor	Assertion	Probability (from 1 to 5)	Assessment of risk (the influence on assertion) (from 1 to 5)	Risk value
1	2	3	4	5	6= 4*5
	The new technology considerably reduces production expenses on some products.	Valuation	3	4	12
2	…	…	…	…	…

Note: 0-10 – low level of risk; 11- 18 – average level of risk; 19-25 – high level of risk.
"The register of risks" can be also used to document risk factors of fraud (table 3).

Table 3. The register of risks concerning fraud

№ п/п	The identified risks	That can go not so as a result of fraud	The influence on financial statement assertions			Risk assessment		
			Assets	Obligations	Report on financial results	Probability	Influence	Risk value
1	Intense situation with cash flows because of overdue delivery according to the large contract	The owner can try to hide losses	valuation	completeness	accuracy	3	3	9
2	…	…						

In case such list is documented in a spreadsheet, risks can be sorted on the basis of probability values, influence, or the combined risk value. For determination a documenting way of these matters it is necessary to use professional judgment.

For testing assessment of risks and internal controls we also suggest to consider financial statement assertions. As an example tests of risk assessment and the controls connected with derivative financial instruments are submitted (table 4 and 5 respectively) [6, p.1189].

Table 4. Test of risk assessment connected with derivative financial instruments (fragment)

№	Financial statement assertions	Test of risk assessment	Test result	Symbols Y1-Y4	Auditor conclusions
1	Completeness, accuracy, occurrence	Does entity have commercial risks?	Yes	Y1	Low level of risk
2	Valuation	Is it checked correctness of assessment model used for determination of the price of a concrete financial instrument?	No	Y4	High level of risk
3		Is it used credit risk in a model of assessment of financial instruments?	Yes	Y1	Low level of risk
…	…	…	…	…	…

Note: Y1 – Low level of risk, Y2 – risk level is lower than an average, Y3 – average level of risk, Y4 – High level of risk.

Table 5. Tests of entity's controls connected with derivative financial instruments (fragment)

№ п/п	Financial statement assertions	Tests of entity's controls	Test result	Criteria	Estimate (from 0 to 100)
Control environment					
1	Valuation, rights and obligations, classification	Do organization's employees have a sufficient level of professional competence for an assessment of financial instruments?	average	high average low	55
2	Valuation, rights and obligations, classification	Does organization have branches or business?	no	yes no	80
3	Valuation, rights and obligations, classification	Does organization have clear formulated and approved by owner policy in the field of financial instruments purchase and sale?	yes	yes no	85
…	…	…	…	…	…
Entity's risk assessment process					
…	Valuation, rights and obligations, classification	Does management carry out a preliminary estimate of transactions proportionally to the risks connected with concrete financial instruments?	no	yes no	15
…	Valuation, rights and obligations, classification	Is it established the limits of the risks connected with use of financial instruments?	no	yes no	18
…	…	…	…	…	…
Entity's information system					
…	Valuation, rights and obligations, classification	Does the entity have functionality or an appropriate configuration for operations with financial instruments?	yes	yes no	82
…	Valuation, rights and obligations, classification	Does entity use the electronic trading platforms for transactions with financial instruments?	no	yes no	81
…	….	….	….	….	…
Entity's control activities					
…	Completeness, accuracy, occurrence	Is it carried out monitoring of trade transactions of individuals?	yes	yes no	86
…	Completeness, accuracy, occurrence	Is it carried out regular verification with banks and depositaries?	not regularly	yes no not regularly	50
….	Completeness, accuracy, occurrence	Is it existed the appropriate division of duties between responsible for carrying out operations and for their verification?	no	yes no	10
…	…	…	…	…	…
Monitoring of controls					
…		Is it carried out monitoring of operational statistical data?	no	yes no as necessary	10
…		Is it existed at organization's computer systems function of generation reports on deviations?	no	yes no	10
…	…	….	…	…	…

Note: from 0 to 10% - no reliability of controls, from 11 to 40% - low reliability of controls, from 41 to 80 - average reliability of controls, from 81 to 100 – high reliability of controls

Besides, it is offered to be guided by financial statement assertions on planning an audit. The example of the audit plan of derivative financial instruments is provided in table 6.

Table 6. The audit plan of derivative financial instruments (fragment)

№	Financial statement assertions	Audit procedures	Document	Expended time (hour)	Method of audit	Performer
1	Rights and obligations, occurrence,	1.1. Legal assessment of contracts 1.2. Expertise of contracts	Contract, agreements; copies of correspondence or the expert opinion (in case of its attraction)	4	Tests of controls, substantive procedures	Petrov A.A.
2	Completeness, Valuation, accuracy	2.1. Audit of the organization of primary accounting operations with derivative financial instruments 2.2. Check of reliability (completeness and accuracy), registration efficiency of transactions wih derivative financial instruments	Contract, agreements; copies of correspondence or the expert opinion (in case of his attraction)	4	Tests of controls, substantive procedures	Petrov A.A.
…	….	…	…	…	…	…

4. Conclusions

The concept development of financial statement assertions is a separate large methodological problem of audit along with research of the audit evidence concept and others concepts, known in the audit theory. In the last years researches develop about material characteristics and different aspects of financial statement assertions. Enhancement of audit methodology assumes detail reviewing of audit evidence and the preconditions of financial statement in the context of standards on auditing. Collection of audit evidence in accordance with the preconditions of financial statement increases reliability of audit evidence and efficiency of an audit inspection as a whole.

It is possible to recognize financial statement assertions as independent category of the audit theory along with the categories "audit evidence", "audit procedures", "materiality", etc.

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