DEVELOPMENT OF THEORETICAL BASICS OF AUDIT AND DETECTION OF ERRORS IN FINANCIAL STATEMENTS

N. Miziakina
National Mining University
19, K. Marks Avenue, Dnipropetrovsk 49600 Ukraine
natalya_m@i.ua

Abstract. The effectiveness of timely monitoring and detection of errors in financial statements largely depends on the understanding both of the essence of the searching object and its types. In this article, it is offered and grounded a new definition and classification system of errors in financial reports that based on the study of the existing approaches to the definition and classification of such errors at enterprises, as well as on modern economic theories and concepts. Also the problems in audit and detection of errors in financial reports in Ukraine are analyzed. The tendencies in development and improvement of the Ukrainian national auditing system as a whole are defined, that is especially important in accordance to the preferred direction of development towards the accession to EU.

Keywords: theoretical basics of audit, errors in financial statements, definition, classification, problems of errors auditing and detection, improvement, Ukrainian auditing system.

Introduction

In the conditions of market economy and developing foreign economic relations, information contained in financial reports of an enterprise becomes the basis of taking economic decisions, for a wide range of users interested in these reports. False or distorted financial information can result in negative and sometimes even fatal consequences for its users. Thus, there arises a necessity of building the system of timely and efficient auditing and detection of errors in financial reports, which would become an instrument of solving the problem of financial reports distortion. Taking into account the intention of Ukraine to integrate into European and global economic area, the problem of developing the system of financial report auditing has to be solved by improving the theoretical and methodological basics of auditing and detection of errors in financial reports of an enterprise with the national features of running business taken into account.

The primary objective in this respect is the definition of the subject matter of the audit, i.e. the error and its essence. The sort of error, its specific features have to be reflected in an appropriate classification of errors, which would help an auditor in the process of financial report auditing to form their own judgment and auditor’s opinion. Presently, while new economic theories and concepts are appearing, these questions still remain underresearched as modern tendencies are not taken into account. So, some aspects that are essential for understanding the notion of “error” still remain unnoticed by auditors. At the same time, to develop theoretical basics of auditing and detection of errors in financial reports of enterprises, there arises the necessity to research those specific barriers that interfere with qualified audit and detection of errors. To find the ways of development and improvement of the national system of auditing, justified and exhaustive information about the current state of this system and its problems is necessary.

The essence of this notion and its definition in financial reports were studied by both national and foreign economists. In their works, the definition of this term is given by B. Usach, V. Riadska, Ya. Petrakov, J. Day, Ye. Dyrkova, V. Kumar, O. Andrenko, O. Shypunova, C. Bradford, J. Downes, J. Goodman. All researchers point out that an error is distortion, inaccuracy, wrong representation of information, however they do not take into account the characteristic features of such information.

Researching the existing errors in financial reports, the scientists try to group them according to certain classification features, defining the types of errors. Significant achievements are observed in this sphere by the following researchers: M. Voitsehovski, O. Zabbaroa, S. Bychkova, O. Filatova, S. Utkyna. As a rule, errors are classified by the following criteria: by the level of significance, by the presence of intention, by the influence on the audit, by the way of correcting it, by the place of occurrence, by the frequency of occurrence, by the period of allowance, by the period of duration, by the level of responsibility of the guilty person, by the
nature of digression, by the content, by the nature of inaccuracy, by the volume of influence, by the stages of preparing financial report when the mistakes occur.

A lot of Ukrainian scholars dedicated their works to the problems of auditing system of Ukraine in general, and to the problems of auditing and detection of errors in financial reports: T. Ocheretko, V.Yevseenko, K. Bezverhii, N. Proskurina, B. Usach, N. Maksymenko, N. Proskurina, O. Shevchuk, V.Kovaliov, V. Patrov, A. Kushnariov, B. Kudritskiy, K. Sakanevych, V. Chubai.

**Results**

The study of works in economics concerning the notion of error in financial report allows distinguishing their common features and giving a typical definition of the above term. Thus, error is an unintentional omission of information of provision of inadequate information in financial report caused by the ignorance or negligence of reliable information that was or had to be available at the moment of compiling the financial report, which might result in disorientation of the final user of financial report.

However, in our opinion, the existing definitions need improvement with modern economic theories and scientific concepts taken into account. Thus, an error is mainly considered to be distortion of information, however, at the same time such important property of information as asymmetry (according to the theory of asymmetric information) is not taken into account. In this connection, we believe that an error has to be considered a certain risk, i.e. likelihood of occurrence of unfavourable events from the viewpoint of risks concept. It is also worth taking into account the transition of this risk on this or that entity of economic relations according to agency theory.

Thus, we offer to define an error in financial report as unevenly distributed deviation of information about factual operations, which altogether carries the likelihood of occurrence of unfavourable events, among the interested economic entities.

However, taking into account the offered definition of an error, to develop the auditing system for financial reports in Ukraine we propose to improve the existing classification of errors by introducing appropriate classification features shown in Fig. 1.

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**Classification features of errors in financial reports**

- **By avoidance**
  - errors that could have been avoided
  - errors that couldn’t have been avoided

- **By the level of asymmetry of information deviation**
  - with zero asymmetry
  - with unity asymmetry
  - with the value of asymmetry between zero and unity

- **By the risk level**
  - low risk of occurrence of unfavourable events
  - medium risk of occurrence of unfavourable events
  - high risk of occurrence of unfavourable events

- **By the nature of risk transference**
  - errors that transfer risk on the enterprise employees
  - errors that transfer risk on the enterprise owners
  - errors that transfer risk on the external users

Fig. 1. Classification features of errors in financial reports

It is expedient to divide errors in financial reports into two groups by the possibility of avoiding them: errors that could have been avoided and errors that couldn’t have been avoided. While in the former group there are errors that could have been avoided by complying with certain subjective conditions, the latter group
of errors is mainly connected with controversies in legislation and normative legal acts regulating the accounting process and drawing financial reports, when this or that requirement contradicts other requirements.

Taking into account that an error in financial reports is primarily a deviation of information as to the actual status of this or that figure of the report, it is natural to assume that such property of information as asymmetry is characteristic of an error, i.e. information about errors in reports is distributed unevenly among the interested economic entities, which indicates the fact of existence of certain informational advantage of some entities over others. By the asymmetry level, information deviation is offered to divide into errors with zero asymmetry, errors with unity asymmetry and errors with the value of asymmetry between zero and unity. Information with zero asymmetry is available equally to all interested parties, for example, errors that couldn’t have been avoided. As for errors with unity asymmetry, their existence, causes and conditions of committing is known to one of the interested parties of economic cooperation, which is characteristic of fraud. All other errors are attributed to the group of errors with the value of asymmetry between zero and unity, as the users of financial report are aware of these errors unequally.

Risk assessment and management is a burning issue of today. It is obvious that an error implies a certain risk or possibility of occurrence of unfavourable events for the users of distorted financial reports. By the level of risk, errors can be: with high risk of occurrence of unfavourable events, when the negative consequences are likely to occur; medium risk of occurrence of unfavourable events, when the negative consequences might occur; and low risk of occurrence of unfavourable events, when negative consequences are not expected. The level of risk characteristic of a concrete error can depend on the value of information deviation, the item of the financial report and other factors. At the same time, the level of one and the same error can be different for different groups of interested economic entities, which is connected with risk transference.

By the risk transference, errors are divided to ones that transfer risk on the enterprise employees, on the enterprise owners, and on external users. The theory of agency relations states that risks, as well as information, are distributed unevenly. Thus, to know the group of interested economic entities exposed to the highest risk would be of help the analysis during the auditing process.

The offered notions and error classification in financial reports will promote the improvement of theoretical fundamentals of audit and error detection in financial reports; it will also have a significant influence on the formation of the auditor’s opinion during the analysis of financial report indicators. However problems existing in this sphere hinder the development of auditing system in Ukraine, and they have to be solved to foster the improvement of the processes of search and detection and errors in financial reports.

Thus, the main problems of audit and error detection in financial reports in Ukraine are summarized in Table 1.

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<th>N</th>
<th>Problem</th>
<th>Brief characteristics</th>
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<td>1</td>
<td>The absence of national standards of audit that are strictly regulated and stipulated at the state level to regulate the processes and procedures of audit and error detection in financial reports</td>
<td>Nowadays, on the territory of Ukraine, International Audit Standards serve as the National Standards, however they do not contain separate standards concerning concrete, strictly determined stage-by-stage procedures of search and detection of errors in financial reports Usach, B. (2007). Taking into account national specific features of economy and doing business in Ukraine, as well as high level of manipulation of financial reports information, the development of appropriate National Standards of Audit on the basis of International Standards would help solving this problem.</td>
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<td>2</td>
<td>Imperfection and instability of legal basis of Ukraine concerning audit in general, which hinders error detection in financial reports</td>
<td>The absence of the relevant independent quality control of the offered auditing service on the level of the state results in the problem of mistrust to the auditor and to the quality of his service (Maksymenko, 2009). Moreover, the quality of auditing services is not connected with error detection in financial reports. That is why the absence of regulation of quality of auditing services results in automatic absence of regulation of error detection.</td>
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<td>3</td>
<td>Imperfection and instability of legal basis of Ukraine concerning the activities of an enterprise in general, which leads to the conditions for purposeful or accidental distortion of financial information in financial reports</td>
<td>There significant barriers of development of high-quality auditing system in Ukraine are: instability of taxation system, constant expectations of even stricter conditions of tax policy. The situation in the taxation sphere is one of the reasons of non-transparency of financial flows of enterprises, tax evasion, as well as the system of “tax optimization”, which creates negative conditions of auditing and error detection in financial reports.</td>
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<td>4</td>
<td>The lack of methodological basics of audit of financial reports concerning error detection and control in financial reports (Proskurina, 2010)</td>
<td>The absence and lack of publicly available auditing and error detection methodologies, the lack of developed templates of documents for error detection and quality of auditing services, as well as typical unified forms of working documents for auditors, management, or textbooks, thorough scientific developments, Ukrainian specialized literature etc.</td>
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<td>5</td>
<td>The difficulty of verifying the financial reports connected with insignificant practical experience of Ukrainian auditors and little number of qualified auditors</td>
<td>In Ukraine, auditing service is a new type of economic activity. In general, institutional situation presently existing in Ukrainian audit does not match the modern state of development of European community. Insufficient efficiency of auditing and error detection in financial reports is as well caused by the absence of professional societies of auditors aimed at creating methodologies of searching, detecting and controlling errors.</td>
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<td>6</td>
<td>Inadequate acknowledgement of the latest developments concerning psychological aspect of the problem of reliability of financial reports during auditing and error detection</td>
<td>The search of error in financial report can be made significantly easier if, along with other methods, auditors use psychological tests that allow detecting individual traits of character of accountants and employees of other financial departments of an enterprise who are responsible for collecting, registering, storing and generalizing information at all stages of accounting process.</td>
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<td>7</td>
<td>Inadequate level of computerization of audit makes error search and detection difficult and lowers the possibility of its detection</td>
<td>Inadequate development of auditing software market in Ukraine, the absence of methodical guidance concerning audit computerization, the lack of specialized software packages aimed at error detection in financial reports (Kudritskiy, 2011).</td>
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<td>8</td>
<td>Inadequate independence of auditors, which leads to situations when the auditor consciously neglects the processes of auditing and error detection in order to give positive auditor’s opinion</td>
<td>Auditing market in Ukraine is comparatively small given the great amount of economic entities, thus there are facts of “ordered” audit. This is also caused by the absence of independent system of auditor’s service quality control.</td>
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<td>9</td>
<td>The absence of common point of view on the question of basic indexes and methods of determining the level of significance of errors detected in financial reports</td>
<td>Judgment on the significance of distortions depends on the auditor’s professional opinion, which leads to difference in results. Thus, one and the same report can be both reliable and unreliable depending on the professional assessment of the level of significance by different auditing companies (Sakanveych, 2012).</td>
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The conducted research on the problems of auditing an error detection in financial reports in Ukraine allows determining the ways of their solution, such as improvement of legal basis, informational and methodological support of the processes of auditing and error detection, development of vocational competence of Ukrainian auditors, auditor’s service market expansion, establishment of efficient quality control system for auditors’ services, development and implementation of computerized error control, search and detection methods, which will develop both theoretical basics of audit and error detection in financial reports, and improve the auditing system in general.
Discussion

On the basis of the study and generalization of the main approaches to the explanation of the notion “error” in financial reports of an enterprise by both foreign and Ukrainian economists, as well as taking into account modern economic theories and scientific concepts, like information asymmetry theory, agency relations theory, and risk concept, we offer to define an error in financial reports as inadequately distributed information deviation about factual operations that altogether implies the possibility of occurrence of unfavourable events among the interested economic entities.

In its turn, the offered definition of error in financial reports helps improving the existing classification of errors by introducing the following classification features: by the possibility of avoiding them, by the level of asymmetry of information deviation, by the level of risk and by the nature of risk transference. Thanks to the adequate number of error types in financial report that can be identified and assessed by the auditor, the risk of proper incorrect auditors’ reports drops, while the possibility of high-quality analysis of enterprise activities and their financial information grows.

Economic system if Ukraine has a range of problems and the sphere of auditing activities is not an exception. In the course of study of modern conditions of Ukrainian auditing system functioning, the main problems of auditing and error detection in financial reports were determined. Furthermore, the determination of the circle of auditing and error detection problems in financial report in Ukraine and the detailed analysis of their essence and causes make the basis for further search and development of ways of solving these problems. It is obvious that the perspectives of developing Ukrainian auditing system mainly depend on the increase in the demand of auditing services. To attract perspective clients – for instance large creditors like banks, leasing enterprises, commodity loan enterprises – the system of Ukrainian audit, both its theoretical basics and their practical realization, has to demonstrate its efficiency, independence, transparency and professionalism.

References


