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System Testing and Annual Accounts Testing as Selection Techniques in Financial Auditing

Munteanu Ciprian-Costel

Doctoral student within "Valahia" University from Târgovişte- Romania

*Corresponding Author

Munteanu Ciprian-Costel

Email: ciprianmunteanu@auditexpertcont.ro

Abstract: This paper aims to present two complex selection techniques in financial auditing - the technique of testing systems and significant accounts, along with the ttechnique of examination of financial statements. Accounting and internal control systems need to be tested regularly and the financial auditor's work simply could not be performed without it. Furthermore, controls of the annual accounts (balance sheet, income statement and annexes) allow the auditor to obtain reliable information on which to draw conclusions about the company. Our main objective is to stress the importance of such selection techniques in the financial auditor's work, as well as to present basic guidelines for their use, their most important characteristics, the auditor's objectives and the use of analytical examination to achieve goals. The auditor aims to understand the accounting and internal control of the customer, to be informed of how these systems are designed and the way they operate. The financial auditor also needs to make sure the financial statements agree with current regulations and contain true information.

Keywords: regulations, assessment, audit opinion, account.

The technique of testing systems and significant accounts

Financial auditing deems significant any item or group of items likely to have an influence on the annual accounts and on their users - owners, lenders, investors.

Since the early stage of orientation and planning of a financial audit, the auditor identifies the significant accounts and systems in order to establish which significant systems and components of internal audit procedures of the company will be subject to assessment. The objective is to determine their reliability, as well as the significant accounts which, by value and / or nature, may hide errors or inaccuracies whose relative importance is directly related to the regularity and honesty of the accounting system, thereby significantly influencing annual accounts.

After such identification, according to the mission plan, as part of the financial auditor's check up of the financial year, the auditor will collect all the necessary evidence to express an opinion, by using financial audit techniques and procedures.

The great advantage is that the testing technique makes use of all the other selection auditing techniques. In general, *the test* is known as a method of examination, either of different characteristics of human personality or of phenomena which cannot be changed. The value of the testing results depends on how they relate to findings obtained by other methods of investigation, as such results do not have an absolute character[1].

In financial auditing, the technique of testing significant areas has as objective to check:

• significant internal audit systems and procedures concerning the correct development and assimilation, by users, as they are stipulated in the company instructions / decisions, existing in the procedures book (compliance testing); depending on the findings of these tests, answers are sought, through substantive test, to the question "are these procedures applied continuously and entirely?";

• significant accounts subject to compliance testing (well-designed chart of accounts and instructions) and substantive testing (the correct and continuous application of the chart of accounts and instructions).

The first responsibility of the management is to ensure successful completion of the objectives set in the strategy. To achieve these business objectives, different systems are set to accumulate related activities, designed to operate together[2]. Objectives are fixed on these systems in accordance with business objectives of the economic entity. To achieve the company main objectives, management must assess

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possible threats on all areas of activity, identifying risks and implementing measures to limit losses.

Global internal control system is conceptual and it is an integrated collection of all control systems used by the entity to achieve its objectives efficiently, by ensuring the characteristics presented in Fig-1:

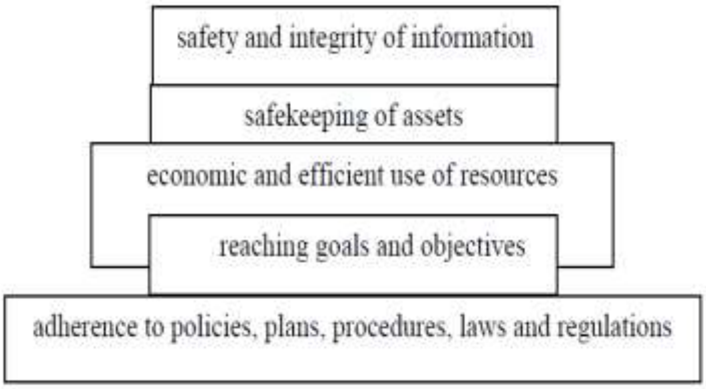

Fig-1: Objectives of the global internal control system

An appropriate control environment is one in which there are adequate internal controls at reasonable costs and where there is a clear indication of commitment to good internal control, by the board and senior executive management.

The nature, extent and intensity of controls vary:

- between departments and within departments;
- depending on the nature of operations;
- depending on the degree of importance of the system;
- depending on the personnel involved; [3]
- depending on the size of the implementation costs of controls.

A systems-based approach is one that examines the function of procedures and internal controls of the system, rather than its outcome. The process requires the auditor to understand consistent operation from start to finish, with its objectives. The auditor must identify system parameters and determine the areas to be examined. When systems are interrelated, it is important to define clearly what areas of control will or will not be audited. This is determined from existing knowledge, discussions with people involved in system operation, system specifications, user manuals and procedures, etc.

The auditor aims to understand the accounting and internal control of the customer, to be informed of how these systems are designed and the way they operate. In the case of accounting systems, follow-up tests must be carried out, which involve pursuing a transaction from the moment of appearance, registration in the accounts and coverage in the financial statements [4].

The assessment of internal controls related to the accounting system should pursue the following objectives:

• Transactions are executed in accordance with specific management authorization and in compliance with legal regulations;

• All transactions are accounted chronologically and systematically, in their correct amount, in appropriate accounts, so as to allow preparation of financial statements in accordance with an identified financial reporting framework;

• Significant accounting records, supporting documentation for all of the assets, revenues and expenses;

• Access to assets and records is done according to the internal procedures manual or in accordance with management's authorization;

• Assets and records are constantly monitored and compared at reasonable timing, and appropriate measures are taken for any inadequate deviations;

• Any change in the capital is accurately reflected in accounting records and in the financial statements;

• Obligations are recorded chronologically and systematically, and checked at reasonable intervals so that any gaps in their evolution can be analyzed so as to take appropriate measures.

External financial auditors are likely that to conduct an exercise similar to that of the internal auditors, in order to achieve their auditing objectives.

Both internal and external auditors may wish to confront each other's views in determining system parameters[5]. Their views on system congruence, that is where a system ends and another begins, may be different, but the principles are common.

At the end of the identification of the system parameters stage, the financial auditor must be able to define, document and agree with company management on:

- congruent areas of the system;
- relationship to other systems and audits;
- audit objectives;
- coverage.

The next stage is to theoretically determine the controls for achieving the desired objectives. There is a wide range of controls, that can be classified as:

 preventive - seeking to prevent the occurrence of inefficiencies, errors or irregularities. Examples of this type of control are: assigning tasks and authorizing controls.

 detective - that operates after the event and tries to detect and correct inefficiencies, errors or irregularities. Examples of this type of control are: reconciliations of bank accounts, checking inputs and outputs.

 directive - which attempts to cause or encourage the emergence of a desirable event. Examples thereof include clear written policies, work procedures and staff training.

Having formed an opinion on the system, the auditor should formulate a *testing strategy*. There are no strict rules regarding the number of required tests. By applying professional judgment, the auditor must determine areas of testing, objectives and performance. Willing to provide an efficient and economical service, the auditor usually tests only significant controls. Such test reduction must not compromise efficiency.

Techniques of examination of financial statements (annual accounts)

The annual accounts (balance sheet, income statement and annexes) are a synthesis of the accounting documents on which the auditor expresses an opinion. Controls on the accounts allowed the auditor to obtain some reliable information on which to draw conclusions about the different positions and headings of the annual accounts.

In order to be able to express an opinion, the auditor should confirm that all the annual accounts are consistent with the auditor's findings, that they accurately reflect management decisions and fairly present the business and financial position of the company.

Overall examination of the balance sheet is mainly aimed to verify if the balance sheet, the profit and loss statement and the annexes meet the following requirements: [6]

- are consistent, taking into account the general knowledge of the company, the sector of activity and the socio-economic environment;
- are presented according to accounting principles and regulations in force;
- take into account events subsequent to closing;
- present a true, clear and complete image of the parameters indicated in Fig-2:

ASSETS, through:
- keeping accurate and up to date accounting records;
- inventory of existing assets, their correct capitalization and coverage of that result in the balance sheet;
- correct performing of operations related to the registration or changes in equity;
- correct evaluation of the assets, according to the regulations in force;
- draw up the balance sheet according to the balance of synthetic accounts;
- correlation of the annexes to the balance sheet

RESULTS, through:
- preparation of the profit and loss statement, based on accounting data from the reporting period;
- establishing net profit and its destinations, as proposed to the General Meeting, according to legal provisions;

FINANCIAL SITUATION, through:
- existence of guarantees for loans and credits obtained or provided by the company;
- existence of sufficient financial resources.

Fig-2: Parameters of the profit and loss statement

The examination technique of the annual accounts rest essentially on analytical examination and, in particular, on:

• establishing indicators of financial analysis and comparing them with those of previous years and of the business sector;

• comparisons between data resulting from the annual accounts and data that is prior, after and forecasted by the company or by other similar companies;

• comparing the percentage compared to the turnover of various items in the income statement.

This analytical examination of the final documents helps update and control the conclusions resulted frm the analytical examination conducted in previous stages.

In particular, attention will be paid that the annexes to the balance sheet comply with current regulations and contain all the important information needed to ensure a full understanding of the balance sheet by its recipients.[7] The auditor must obtain reliable information, in sufficient quality and quantity, to ensure that the annexes, in their content and information provided, are sincere and that, along with the other documents of synthesis, they offer a true image of the activity of the company.

For financial statements to be prepared in accordance with regulations in force, the auditor must make sure, in particular, that:

• The precautionary principle and the principle of business continuity are complied with. In case of partial or total end of the business, the auditor takes into account the foreseeable incidents at year end;

• The accrual principle has been applied; the auditor verifies if revenues and expenditures of the year were recorded;

• The balance sheet is drawn in a comparative form, the methods of evaluation and presentation are identical to those of the previous year; if changes occur, they must be recorded and justified in the Annex;

• Assets and liabilities are registered separately, without compensations;

• The opening balance corresponds to the closing balance of the previous year;

• For each account, the auditor should check the registrations, the credibility of its components and balance;

• Inventory data of assets and liabilities are grouped in the inventory ledger, on quantity and value, respectively. The auditor performs a comparison between the accounting amounts and the inventory values provided by the company, assessing their credibility[8].

During the verification of the financial statements, the auditors conduct their best efforts to check and comply with the following rules:

Balance sheet

- *Equity*; the auditor checks the registration in equity accounts of related operations, according to the resolutions of the general meetings;

- *Loans and similar debts*; the auditor asks for documents that allow him to follow in detail the respective operations;

- *Assets*; the auditor checks the documents allowing to follow in detail all assets and their amortization or depreciation;

- *Stocks and production in progress*; the auditor asks for a detailed status and amounts representing stocks and production in progress, as well as the provisions established for the impairment related to them, made at the closing date of the financial year or on a date as close as possible. The auditor obtains from the management the description of the methods used to assess stocks and production in progress[9]. Auditors must ensure these methods comply with current regulations and must verify their application, by using sampling;

- *Third-party accounts*; the auditor asks for documents, such as:

- balances of the analytical accounts, ensuring their compliance with the general synthetic accounts;

- an inventory of existing assets and liabilities at year end. The auditor examines, possibly by using sampling, the balances of third parties accounts, based on available accounting documents and information. Auditors ask to make corrections, if necessary.

- A*ccounts for adjustments and related accounts*; auditors check the incorporation into these accounts only of expenses and revenues referring to its content.

- *Provisioning accounts*; the auditor checks how provisions are established on the basis of necessary supporting documents and their proper recording in the balance sheet or annexes. He or she ensures that these provisions are well accounted for, taking into account the risks and losses incurred between the year end and the balance sheet writing date, or between the balance sheet writing date and the date of its verification by the auditor.

- *Treasury accounts*; the auditor makes sure the company periodically prepares a comparative situation of the balances of each treasury account as registered in the accounting books comparing it to the bank account statements; the auditor checks these comparative situations at least once a year.

The income statement (profit and loss statement). At the end of the financial year, the auditor:

- examines some expenditure accounts, such as: rent, insurance, commissions and fees, taxes, salaries, social charges, loans and credits, tax statements, various contracts and payments made on their behalf;
- examines tax bases established for tax purposes and taxes on revenue accounts;
- examines, possibly along with company management, the inadequacies and deficiencies and suggests, if necessary, making appropriate corrections, to the extent that they are justified;
- examines the comparative analysis of the various accounts of revenues and expenditures, analyzing intermediate management balances, setting the necessary conclusions.

Annexes - The auditor asks the annexes to the balance sheet, analyzing:

- The evolution of the accounts presented by these annexes, the measures taken or planned by the company management;
- The compliance with the methods of evaluating entries in the balance sheet and profit and loss account;
- The methods used to calculate depreciation, provisions and their justification.

After various checks and tests performed on the accounts, the auditors could gather a number of reliable information which enabled them to draw conclusions for the different positions and headings of the annual accounts (balance sheet, profit and loss account, annexes)[10]. These controls have enabled the financial auditors to gain a better understanding of the company, of its business, of the variations as compared to the previous year.

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