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CREDIBILITY VERSUS MEASUREMENT OF VALUE OF A FINANCIAL STATEMENT CONSTITUENTS IN THE CONTEXT OF AUDITING RISK

Summary
Preparing financial statements is essential for each business entity in order to transmit information necessary for the intended user. The statements must reflect current financial situation of the company on the basis of which it will be possible to take appropriate decisions. Information is only reliable when it is useful. Preservation of credibility of financial statements in business practice raises doubts relating to the possibility, allowed by the International Accounting Standards, to present estimates. Another concern is connected with the increasing usage of fair value measurement instead of the principle of prudence[1]. The aim of the paper is to define the notion of credibility with respect to elements of financial statement, auditing risk of these elements and application of estimates. The author also highlights the essence of fair value measurement and the impact of financial auditing on shaping the credibility of information in the financial statement. For the purposes of the paper the author researched the legal acts in force and used the case study method.

Key words: *financial statement, audit risk, credibility*

Introduction

Accountancy as a system of economic recording is a source of business information about each company. It shows financial situation of a business entity to both internal and external recipients. Accountancy is also a scientific field and elementary source of information which examines, explains and uses description of the value and nature of a firm's assets, liabilities and owner's equity on daily basis. The essence of accountancy lies in the fact that it embraces the overall wealth of

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[1] J. Bodzianny, D. Markiewicz –Rudnicka, *Wiarygodność sprawozdań finansowych a wartość godziwa*, WSB University in Wrocław, p. 1.

a company, information about the origin of this wealth as well as development of economic processes.

1. Credibility of constituents of a financial statement

The aim of audit of elements of a financial statement is to determine the accuracy of the balance sheet and the financial result. It is regulated by a resolution of the Polish Council of Ministers on audits of financial statements in state-owned companies[2]. Another relevant regulation refers to substantiation of the audit by means of a protocol confirming the accuracy of the financial statement or pointing to areas for corrections to be made in a set period of time. Pursuant to the regulation the organs responsible for conducting the audit were audit committees constituted for an indefinite period of time. The composition of the committees included auditors appointed by the Minister of Finance.

It is unavoidable that each financial statement may contain consequences of errors made in the course of entering information in the books or caused by unconscious omission of economic occurrences. The key aspect here is examination of irregularities in the annual financial statement and determination of errors which could possibly lead to false impressions or wrong decisions taken by the receiver after studying the data included in the financial statement[3]. Each business entity responsible for preparation of a financial statement should strive towards credible presentation of financial information because this information is critical in shaping the right opinions and decisions.

Application of International Accounting Standards offers possibility to walk away from the principle of prudence and which, in the view of the Accounting Act[4], involves obligatory inclusion in a financial statement of a business entity as at the balance sheet day all occurrences which caused decrease in the value of assets or threat of losses and as a consequence events which impacted the financial result. Application of the model of fair value measurement may lead to a situation in which

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[2] Resolution 332 of the Polish Council of Ministers of 16 August 1957 on audits of financial statements in state-owned enterprises acting on the basis of economic settlements (M.P. No 73 of 1957 item 438).

[3] J. Pfaff, *Rewizja finansowa wydanie II poprawione i uzupełnione*, Publishing House of the University of Economics in Katowice, pp. 61-73.

[4] The Accounting Act of 29 September 1994 (Journal of Laws of 2013 items 330 and 613; Journal of Laws of 2014 items 768 and 1100; Journal of Laws of 2015 item 4).

a financial statement does not respect the requirement of true and reliable picture[5].

The definition of fair value can be found in the International Financial Reporting Standard No 13 on *Fair Value Measurement*. This standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy', which results in a market-based, rather than entity-specific, measurement. It is such kind of a price that can be obtained for sale of a constituent of assets, or a price that must be paid as the result of transfer of liability between market participants on the date of valuation[6]. This definition is convergent with Article 28 item 6 of the Accounting Act[7], which stipulates that *the fair value is an amount for which a given asset could be exchanged, and a liability settled in an arm's length transaction between willing, well-informed and non-related parties*. Both definitions treat the net sales price as an equivalent to the so called 'exit price'. When fair value is determined on an active market it acquires all advantages and disadvantages of the applied standards of current net sales price. High credibility is assigned to market prices. In an event when the fair value must be measured, the credibility is diminished[8]. The advantages coming from the fair value are presented in Table 1.

[5] J. Bodzianny, D. Markiewicz – Rudnicka, *Wiarygodność sprawozdań finansowych a wartość godziwa*, WSB University in Wrocław, p. 1.

[6] J. Gierusz, *Pomiar wartości aktywów i zobowiązań w świetle MSSF 1,Wycena w wartości godziwej,* http://jmf.wzr.pl/pim/2012_4_3_16.pdf , pp. 1 - 13 [access 22 October 2016].
Wycena w wartości godziwej, http://jmf.wzr.pl/pim/2012_4_3_16.pdf [access 22 October 2016].

[7] The Accounting Act of 29 September 1994 (Journal of Laws of 2013 items 330 and 613; Journal of Laws of 2014 items 768 and 1100; Journal of Laws of 2015 item 4, article 28 point 6).

[8] J. Gierusz, *Pomiar wartości aktywów i zobowiązań w świetle MSSF 13 Wycena w wartości godziwej,* http://jmf.wzr.pl/pim/2012_4_3_16.pdf , pp. 1-13 [access 22 October 2016].

Table 1. Advantages of the fair value

Advantage	Description
Prospective picture	Fair value offers better possibility of copying the ability of a business entity to make successful cash flows in the future than in the case of application of historic cost principle. It allows estimation of the accounting value of this entity's capital with respect to its market value.
Grounds for valuation of some effects of economic decisions	Offers possibility to compare profitability of such financial instruments which demonstrate similar economic profile. Allows for skills evaluation conducted by executives or other persons responsible for company management with respect to the adopted and conducted investment policy.
Costs realignment	Measurement of assets according to fair value better meets the principle of cause-and-effect matching of costs and revenues because current selling prices of products are replaced by real not historic costs.
Flexible solutions	It is possible to use different variants of value measurement which helps business entities choose the most useful technique with the best specificity for the item under valuation and opens access to market information.
Alternative for historic cost	In some cases fair value measurement is the only possible valuation method.

Source: Own work based on: B. Gierusz, T. Martyniuk [2009] Rola rachunkowości w świetle społecznej odpowiedzialności przedsiębiorstwa[9].

The obvious drawback of fair value is the fact that the value determined on an active market is purely hypothetical[10].

The Accounting Act also defines the way of presenting information. It offers guidelines for recording of economic occurrences of financial nature in the books of accounts and in the financial statement in accordance with their economic content[11].

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[9] J. Gierusz, *Pomiar wartości aktywów i zobowiązań w świetle MSSF 13 Wycena w wartości godziwej,* http://jmf.wzr.pl/pim/2012_4_3_16.pdf , pp. 1-13 [access 22 October 2016].

[10] Ł. Matuszak, *Wycena a wiarygodność i porównywalność sprawozdania finansowego*, Poznań 2012.

[11] M. Adamczyk, *Jakość informacji finansowych jako podstawa wiarygodności sprawozdań finansowych jednostek samorządu terytorialnego,* Scientific Journal of the

In order to assure credibility of financial information, the presentation of data should correspond to the economic content. Impartiality is an important condition which guarantees credibility of a financial statement. It is related to the principle of prudent valuation, completeness and economic aspect i.e. the cost of obtaining the data versus their informative value.

Article 24 of the Accounting Act describes requirements so as to the manner of keeping the books of accounts. The books must prove credibility of a financial statement. The regulation states clearly that the books of accounts should be kept in a reliable, error-free and verifiable manner and on an ongoing basis. The documentation of entries must allow for identification of documents and the manner in which they were recorded. Entries must be kept in a chronological and systematic order. Completeness and access to data must be ensured. In order to assure credibility of information included in a financial statement, impartiality is required. The communicated information is impartial when it is not received as intentional or when there is no visible interference which would trigger a certain reaction or impact the user's bevaviour[12].

The issue of credibility raises a considerable number of doubts in the accounting practice. The reason behind these doubts may be the fact that the International Accounting Standards allow to use estimates in the financial statement. IAS No 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines estimates as such approximations which may need verification when additional information becomes available. The example refers to determination in a financial statement of profit or loss generated as the result of a conditional occurrence, which does not constitute error correction[13]. The changes in value are the consequences of new information or occurrences. It should be emphasized that appropriate interpretation of a financial statement is possible thanks to the knowledge of a given set of accounting principles applied by an organisation. That is why it is important to provide the grounds behind the choice of particular principles available within the range compliant with IFRS as well as any other additional information on the applied measurement methods. In business practice it is sometimes

University of Szczecin No 718, *Finanse. Rynki finansowe. Ubezpieczenia* No 53, 2012, pp. 1-12.

[12] Ibid.

[13] IAS No 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, Official Journal of the European Union, pp. 1-8.

the case that measurement is conducted based on various models what results from the lack of information on current market prices. According to IFRS, the information relating to uncertainty with respect to value estimates must be disclosed. The disclosure obligation especially refers to the following:

- assumptions of future occurrences which may impact the reserves presented in the balance sheet;
- applied methods as well as significant assumptions for fair value measurement of tangible assets in revalued amounts, investment properties valued in accordance with information coming from the market or other factors subject to disclosure, financial assets and liabilities and assumptions used for measurement of fair value of intangible and legal assets in revalued amounts[14]. One of possible ways of counteracting the loss of credibility is audit of financial statements conducted in accordance with guidelines to be found in the Polish Domestic Accounting Standard No 7 *Changes of accounting policies, correction of errors, changes in estimates and events after balance sheet date.*

2. Risks of auditing elements of financial statements

International Standards on Auditing (ISAs) and Domestic Auditing Standards put special emphasis on risk assessment. The term *risk* is defined in ISA 200, which stipulates risk as a possibility that the auditor will express an inappropriate audit opinion in a situation when the financial statements are materially misstated. Risk assessment is a pre-condition for a correct audit of a financial statement. The evaluation of risk is broadly related to the situation of the audited business entity. The audit conducted by a certified auditor ought to provide reasonable assurance that the data presented in a financial statement is free from material misstatements, whether due to fraud or error. International Standard on Auditing No 200 defines the risk of material misstatement as the risk that the financial statements were materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

[14] J. Bodzianny, D. Markiewicz – Rudnicka, *Wiarygodność sprawozdań finansowych a wartość godziwa*, WSB University in Wrocław, pp. 186 -187.

- the inherent risk,
- the risk of internal control.

The first type of risk - inherent risk - is the 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[15]. The second type of risk - control risk – is the 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.[16]

The auditing risk is a product of three ratios: the inherent risk, control risk and detection risk. The inherent and control risks remain outside the auditor's mandate. The detection risk must be well adjusted by the auditor. It means that material misstatements once overlooked by internal control may not be detected by the external audit.[17] The three kinds of risks together with factors increasing their emergence are presented below. Interrelations between different kinds of risks are shown in Table 2.

Table 2. Interrelations between different kinds of risks

Detection risk lowest	**Detection risk medium**	**Detection risk highest**
Inherent risk: high	Inherent risk: low	Inherent risk: low
Control risk: high	Control risk: high	Control risk: low

Source: Own work based on: M. Adamczyk, *Jakość informacji finansowych jako podstawa wiarygodności sprawozdań finansowych jednostek samorządu terytorialnego*, Scientific Journal of the University of Szczecin No 718. Finanse. Rynki finansowe. Ubezpieczenia No 53, 2012.

[15] Glossary of financial audit terms available at http://www.ifac.org/system/files/downloads/ Polish_GuidetoUsingISAs_Glossary.pdf, p 21 [access17 July2016].
[16] Ibid., p. 20.
[17] M. Adamczyk, *Jakość informacji finansowych jako podstawa wiarygodności sprawozdań finansowych jednostek samorządu terytorialnego*, Scientific Journal of the University of Szczecin No 718, *Finanse. Rynki finansowe. Ubezpieczenia* No 53, 2012 , pp. 1-12.

Example: Auditor companies generally assume the audit risk at the level of 5% which means that there is 95% of certainty that the issued opinion is fair and correct. In an event when the auditor assesses the inherent and control risks as high (with respective values of 80% and 70%) it means that the audited business entity made 80 errors per 100 documents and internal control does not discern 70% of them i.e. 56 errors. To achieve the standard audit risk of 5% the calculation proceeds as follows:

Detection risk = Audit risk / Inherent risk x Control risk

Detection risk = 0.05 / 0.8 x 0.7 = 0.089

The above calculation shows that the detection risk should be determined on the level of 0.089 (so it should amount to 91,1%)[18]. The calculation presented above allows for determination of the detection risk and determines stages of limiting the audit risk.

The nature of a given business entity makes it possible to determine the value of particular risks which result from this very nature and which become clear for each and every experienced auditor. Credible information coming from an audited financial statement guarantee that the receiver will dispose of reliable data about the company's wealth and its financial situation.

Conclusions

Together with the development of economy rises the need to get access to economic information about the performance of business entities. It is accountancy that provides this data. Without accountancy efficient functioning of companies would not be possible. External users obtain the information they desire from data included in the financial statements. An important role of accountancy is then the provision of reliable and clear information about the wealth and financial information of a business entity and its performance and financial results. Therefore the financial statement released to the outside world must necessarily be of the highest possible quality. An auditor should be a guarantor of this high quality. Nevertheless, one must bear in mind that each financial statement may contain some errors or consequences of errors which were

[18] A. Kwasiborski, *Dokumentacja rewizyjna z badania sprawozdania finansowego*, Rewiks Sp. z o.o., Warszawa 2004, pp. 17 – 19.

committed in the course of recording the economic transactions into the books, inventory proceedings or omission of relevant economic occurrences. Once the information is regarded as insignificant, trying to retrieve it would not be rational as the costs related to the retrieval of this information would be higher than the expected results and the costs of detected errors.

Legal acts

[1.] Resolution 332 of the Polish Council of Ministers of 16 August 1957 on audits of financial statements in state-owned enterprises acting on the basis of economic settlements (M.P. no 73 of 1957 item 438).

[2.] Act of 27 August 2009 on Public Finance (Journal of Laws of 2009 No 157 item 1240 article 7 point 1).

[3.] The Accounting Act of 29 September 1994 (Journal of Laws of 2013 items 330 and 613; Journal of Laws of 2014 items 768 and 1100, Journal of Laws of 2015 item 4).

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[2.] Bodzianny J., Markiewicz – Rudnicka D., *Wiarygodność sprawozdań finansowych a wartość godziwa,* WSB University in Wrocław.

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[5.] Kwasiborski A., *Dokumentacja rewizyjna z badania sprawozdania finansowego,* Rewiks Sp. z o.o., Warszawa 2004, pp. 17 – 19.

[6.] Matuszak Ł., *Wycena a wiarygodność i porównywalność sprawozdania finansowego,* Poznań 2012.

[7.] IAS No 8 Accounting Policies, Changes in Accounting Estimates and Errors, Official Journal of the European Union, 29 November 2008.

[8.] International Financial Reporting Standard No 13.

[9.] Pfaff J., *Rewizja finansowa wydanie II poprawione i uzupełnione,* Publishing House of the University of Economics in Katowice.

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