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THE IMAPACT OF AUDIT AND RELAIBILITY OF FINANCIAL ACCOUNTS

Mr F.K Musweu* **Mr A.Susairaj*** **Dr L.Subburaj****
**Assistant Lecuter,DMI St Eugene University ,Zambia.*
***Sr Lecturer, DMI St Eugene University, Zambia.*

Abstract
Reliability is known be one of the qualitative characteristics of financial statements in financial reporting or financial accounting. Companies are required to prepare financial accounts periodically, though it not mandatory for the other business entities such sole traders and the partnership businesses. In most cases ownership of a business entity is separated from its management and this separation is mandatory for companies. The owners of the business are eager to have faith in the financial accounts prepared by their managers they have hired. The owners of the business are said to have an agency relationship with their managers. Furthermore the owners of business do have an agency relationship with their auditors. Therefore the focus of this article is to explain how auditing does add to the reliability of financial statements for the users to have faith in the information contained in the financial statements. In order to discuss this topic we will explain reliability as one of the qualitative characteristics of financial statements, the agency relationship between the owners of the business (shareholders for the company) and there managers, the agency relationship between the owners of the business and the auditors. The information in article is entirely collected through secondary research, specifically from scholarly articles in accounting and financial, various text books in accounting and finance and journals from professional bodies such as ACCA, ZICA, AAT and CIMA. The scope of this article is focused on the Zambian scenario.

Keywords: Accounting, Management Accountability, Reliability, Internal Controls, Financial Statements, External Controls.

Introduction

This article discusses the agency relationship between directors and the shareholders as well as other groups with an interest in the company known as stakeholders. In addition another agency relationship between the auditors and shareholders are also discussed. Furthermore the reliability of financial statements is explained coupled with the concluding remarks on how the audits of financial statements can an aid to the reliability of financial statements.

The Agency Theory

Agency theory is term that is frequently used to give a description of the relationships that exists between the various parties possessing various interests in a firm and interested in archiving different objectives. The agency theory can help to explain the different duties the parties may perform and conflicts that may occur in the firm.

Shareholders and Directors

The commonest of these relationships is the relationship between the shareholders and the directors of the firm. This agency relationship is derived from the separation between ownership and control of the company. Separation between ownership and control is particularly huge in large companies especially those listed on the stock exchange. Such companies are known to be complex and have a feature of

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requiring substantial investments in equity in order to finance them i.e. usually a large number of shareholders acquire shares from such companies, hence they have large number of shareholders.

Shareholders hire professional managers (the directors) to run the company on their behalf. The shareholders are the principals and the directors are the agents. An agency relationship is created between the shareholders and the directors. Directors as agents of the shareholders are required to operate in the best interests of the shareholders. In company law this is referred to as the fiduciary responsibilities of the directors to the shareholders. The primary objective of the directors should be to maximise wealth of shareholder as the company was originally set up to create wealth for the shareholders who regarded to be the owners of the company. The two major hallmarks of shareholder's wealth maximisation are increasing the share price and the dividend payout.

Agency Problem

Potential conflict of interests between directors and shareholders may develop and this may be mainly due to the separation of ownership and control. The objectives of the directors as agents and those of shareholders may in most cases differ. The directors desire large bonus, high salary, status and etc. and they place a lot of interest in ensuring that there desires are achieved. The desires of the directors are of course there major personal objectives in the company that will differ from the principal's objectives of shareholder's wealth maximisation and yet the principle's objective should be the primary objective of the directors.

The underlying problem is that directors pursue selfish interests rather than pursuing the objectives of the principal. This is worsened by the fact that shareholders normally do not play an active role in the day-to-day management of the company, but rather they play a passive role.

The agency problem has been a key area of corporate governance focus with several companies collapsing, caused by directors who are normally over-dominant. This has necessitated active debate about the powers of the directors, and how shareholders can seek to ensure that directors do not abuse their powers.

Stakeholders and Directors

It is also important to state that apart from shareholders there other parties interested in the affairs of the company and these are collectively known the stakeholders and they should also be seen to play an active role in ensuring that directors act in the best interest of the company. Experts in finance argued that while maximisation of shareholder wealth is important, cannot be the single overall objective of organisations, and account must be taken of broader economic and social responsibilities.

Various legislation has been enacted and reports have been published which seek to improve the control that stakeholders including shareholders can exercise over the directors of the company.

Shareholders and Auditors

The relationship between the shareholders and the auditors is another principal-agent relationship that is dealt with by corporate governance guidelines. Using vehicles such as the annual general meeting and general meetings shareholders hire the auditors through voting to undertake the audit of the financial statements of the company. Although the directors are given the mandate to fill in casual vacancies of the auditors to replace the auditors who have vacated there position as auditors for various reasons until the next general meeting or annual general meeting.

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In the corporate governance debate the agency theory can help to explain the actions of the various interest groups. By providing an independent review of the financial position of the organisation an audit is seen as a key component of corporate governance.

The auditors act as agents to the principals (the shareholders) when conducting an audit this relationship brings concerns with regard to trust and confidence as the auditor-shareholder relationship. The auditors will have their own interests and motives to consider when conducting their duties. On the other hand performance of an audit necessitates a close working relationship with the directors of a company.

This close relationship between auditors and directors undermines the independence of auditors. The shareholders question the perceived and actual independence of shareholders which is compromised due to close relationship with directors. Therefore tougher controls and standards have introduced to reduce or eliminate the independence of auditors being compromised.

The primary aim of an audit is to enable the auditor to state that "these accounts show a true and fair view" or, of course, to state that "they do not show a true and fair view".

Therefore auditing is the examination of, and expression of opinion on, the financial statements of an entity to provide reasonable assurance that the information in the financial statements truly portrays the financial standing and results of the company for the period covered by the financial statements.

When the auditor has examined the entity, its record, and its financial statements, he produces an audit report addressed to the owners/stakeholders where he expresses his opinion of the truth and fairness, and sometimes other aspects, of the financial statements.

Statutory and non-statutory audits
The audits conducted by auditors can either be in the form of statutory or non-statutory audits and they explained below.

Statutory Audit
Statutory audit are audits that are required by law or regulation. The audit of such entities is compulsory and not optional; the financial statements are audited as per relevant legislation. For instance under the company’s act it is a requirement that every company needs to have its financial statements audited by external auditors.

Non Statutory Audit
Non statutory audits are performed because the owners of the entities or other interested parties want the audits to be conducted not that they are required by legislation to have their financial statements audited. In other words the audit is not compulsory, but it is rather optional. This has had an effect of extending audits to entities such as clubs, charities, sole traders and partnerships.

This means that auditing may extend to every type of undertaking which produces accounts including clubs, charities, sole traders and partnerships.

Unlike sole-trader-ship, partnership, or non-profit organizations auditing financial statements for companies is mandatory. There are however, certain advantages in having financial statements audited

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even where no statutory requirement exists for such an audit in the case of a sole-trader-ship, partnership, or non-profit organizations for example.

Reliability

Information is reliable when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. Reliability is influenced by faithful presentation, substance over form, neutrality, prudence, timeliness and completeness. “P 4 10, 1998, Marius Koen”

Recommendations and Conclusion

Based on the audit conducted, the auditors can offer assurance to the users of statements that the information in the financial statements is credible and that the financial statements portrays a true picture of an entity’s financial position and results for the year covered by the financial statements. Although due to the various limitations which occur when conducting the audit the auditor does not give absolute assurance about the credibility of the financial statements, but rather they give a reasonable assurance. Therefore the audit does not guarantee future viability of the entity, or that the fraud and error has not occurred and generally that a material misstatement has not occurred in the financial statements.

It should also be noted that management is entrusted with the responsibility to ensure that the entity is viable and that any errors error or fraud that may occur is detected. Thus it is not the auditor’s responsibility to detect fraud, the auditor’s duty is carry out the audit in a professional manner and with due care, abiding by the auditing standards and codes of ethics to provide reasonable assurance that the financial statements are not materially misstated due to fraud and error.

Therefore despite the limitations stated above it is vital to state that the audit of financial statements do add to the reliability of financial statements as the users of financial statements are at least able to have faith in the information contained in the financial statements after the audit is conducted and audit report is produced.

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