USING AUDIT METHODS IN THE AUDITING OF NON-CURRENT ASSETS OF THE MUNICIPALITY

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Abstract: *The paper deals with using audit methods in the audit of non-current assets of the municipality. Due the fact that surveyed area is audit of the municipal assets, we made a literature review in this area. Each municipality in Slovakia has legal obligation of audit of its financial statements. Audit in the municipality contains a high detection risk because the independent auditor cannot reveal always so-called hidden ownership or family ties. High detection risk may lead to failure of the auditor. Due to avoid of possible auditor's failure, he or she needs to know the pitfalls accompanying audit engagement. The main objective of this paper is setting methods for the audit of non-current assets in respect of which audit risk is reducing. In the first part we have introduced a brief development of audit in Slovakia from 1989 to the present days. This part of the paper is devoted to the history of the audit and its current legislative framework. In Slovakia, international standards on auditing are applying for over ten years, and the Code of Ethics for auditors as well. Three components of audit risk affecting the overall audit risk are presented in the second part. This section lists the pitfalls in the audit of non-current assets of the municipality and suggested audit procedures, how to avoid them. Examined issue was applied on the example of the audit of non-current assets in municipality of Slovakia. Recognizing the potential audit pitfalls leads the auditor to reduce the overall audit risk. The auditor must follow the objectivity and independence from the audited entity, to recognize transactions with related parties especially in the municipality, and avoid failures in the design and the performance of appropriate audit procedures. Proper setup of the audit methods leads auditor to minimize audit risks to an acceptable rate and to formulate audit opinion. Conclusion of the article contains a risk assessment, audit planning and solving of audit pitfalls in the area of non-current assets.*

Keywords: *Auditing; Non-Current Assets; Municipality; Financial Statements.*

JEL classification: M41; M42; H83.

Introduction

The municipality in Slovak Republic is a legal person which according to law manages its own income and property. It is an independent administrative and self-governing territorial unit of the Slovak Republic. The municipality unites persons having their permanent residence. Fundamental role of the municipality in the performance of self-government is considered the care for the needs of its people and development of its territory. The management of the municipality independently manages and realizes all the tasks related to its self-administration. Law on Municipalities (1990) is the highest legal standard for the management of the municipality. Compliance with all governing laws is part of the audit of public administration. System of control in public administration in Slovak Republic has undergone a number of organizational and competence changes since 1990 (Kočiš, 2007). However that audit is considered more like verifying activity than control, it is considered as an undetectable part of control of public administration units. Audit helps to fulfil the economy, efficiency and effectiveness of activities of public administration entities. It also provides a systematic approach to improve the efficiency of their financial management. Audit verifies and evaluates the risk management system of public administration entities, and it identifies and assesses possible risks related to financial management. According Law on Financial Control and Auditing (2015), audit verifies the accuracy and verifiability of carrying out of financial operations; and it verifies and evaluates the reliability of reporting. It also verifies the completeness and correctness of accounting of public administration entity. In principle, audit is a tool at preventing and detecting accounting errors and property fraud.

1. Literature review

An overview of the governmental accounting status quo in Europe by analysing the public sector accounting, budgeting and auditing systems in fourteen European countries wrote Brusca et al. (2015). Authors have described challenges faced by European countries as they move towards adoption of the European Public Sector Accounting Standards (EPSAS). Handzic et al. (2008) have proposed a knowledge management audit model to assist organisations to obtain an accurate picture of their knowledge-based assets and the strategies used to manage that knowledge across the organisations. The model also serves as a mean for assessing how well the identified assets and strategies meet organisational business goals and strategies. Authors illustrated model in the local government environment with implication of such an audit. Many countries are reforming their accounting systems and are using, or are planning to use, accrual based accounting (Lande and Rocher, 2011). Their article explains what needs to be considered to apply accrual accounting successfully in the public sector. These authors highlighted the issues that international accounting bodies need to address (e.g. taxation and intangible assets). Phelps (2010, 2011) has explored the link between rationale, practice and outcomes in municipal property asset management and through this to gain an improved understanding of the emerging discipline of public sector asset management. This author has developed analytical framework comprising models to measure why councils carry out asset management – rationale; how they do it – practice and what outcomes they achieved. He found recognizable link between rationale and practice, but the link between practice and outcomes was unproven. Critical success factors for effective asset management were strategic focus, organisation will, portfolio intelligence and an entrepreneurial culture. Thus, the effective asset management remains a problematic area requiring further research. The author concludes his work by stating that property asset management is a discipline of growing significance for local government across the world. Sharma et al. (2008) has described an asset level of service determination methodology, which could be integrated with decision support systems as a performance indicator. Proposed asset level of service is a composite level of service for different users of the infrastructure system. The developed framework includes accounting for qualitative factors, such as neighbourhood, safety and aesthetics. Bogdan (2016) has shown a quantum approach to reduce the risk of error in the accounting estimates and judgments and managerial decision.

2. Research and results

2.1. Historical background of audit

History of audit is connected with the need to inspect commercial transactions in ancient Egypt, where the individual accounting cases were writing down on clay plate. Public accountants were selected by a lot to manage and control public finances in Greece (Kareš, 2015). North Italy cities were considered as predecessors of state control authorities in area of transactions verifying. In 1581 in Venice was established professional association of auditors which dealt with verification of the accounting transactions. Verification was conducted by a qualified person, and thus it became the fixed component of the Italian economy. Companies Act from 1884 in Britain created a modern form of legislation related to the audit. Under this Act, one or more shareholders were involved in verification of the correctness of the balance sheet of the company compiled by management. Shareholders were also authorized to verify accounting and books of companies. Balance sheets and the applied reports were distributed to shareholders and archived in the register of joint-stock company (Kareš, 2015).
Situation in USA was similar with the meaning of that a publication “Memorandum of Auditing of the Balance Sheet” or “Unified Accounting” was published in the report of Federal Reserve in 1917. The meaning of financial statements was emphasized in 1929, when the report of Verification of Financial Statements dealt with the Income Statement. US companies which fulfil certain conditions are required to audit their financial statements, according the Law on Securities and Exchange Commission from 1934. These companies must submit a report to the Securities and Exchange Commission. American Institute of Certified Public Accountants issued Generally Accepted Auditing Standards (GAAS) in accordance with which the audit must be conducted (Kareš, 2010).

2.2. Audit in Slovakia

In 1989, Federal Ministry of Finance approved the Decree on the verifiers and their activities. According the Decree, first verifiers had audited the financial statements for the 1989 year. This Decree was replaced by the Act no. 73/1992 Coll. on Auditors and the Slovak Chamber of Auditors (SKAU), which adopted the Slovak National Council. In 2007 came into force Act no. 540/2007 Coll. on Auditors, Audit and Supervision of Auditing (Kašiarová, et al., 2015). The Act no. 423/2015 Coll. on Statutory Audit was adopted in 2015 year. The audit in Slovak Republic is thus subject to its own legal norms of national legislation, norms adopted by SKAU, international documents and standards adopted by EU (Bránιková, et al., 2011). The General Assembly of Slovak Chamber of Auditors declared resolution valid from 2005, according to which the audit must be conducted in compliance with international auditing standards issued by the International Federation of Accountants. Auditors in Slovakia must perform their activities in accordance with the Code of Ethics adopted by SKAU, which determines all activities undertaken by auditors (Maděra, 2014). When we sum up, the audit is a systematic and objective process of assessment and obtaining evidence containing information on economic events and activities, in order to assess the scope of the conformity between the conditions and the detected information and notify outcome to relevant stakeholders (Hakalová, 2010).

2.3. Compiling and audit of financial statements of public sector entities

Public administration entities in Slovak republic (cities, municipalities, and higher territorial units, contributory and budgetary organizations) are required to compile the individual financial statements under the Accounting Act no. 431/2002 Coll. Their individual financial statements (except contributory and budgetary organizations) must be verified by the auditor. These entities have also the obligation to issue an annual report which conformity with the individual financial statements must be verified by the auditor. Audit of the individual financial statements of the entity of public administration differs from the audit of financial statements of the business entity. It is mainly due the framework of financial reporting and regulatory environment of management and operation of the entity (Brániková, et al., 2011). The influence of institutions in reducing-control corruption in the state of EU analysed Gherai et al. (2016).

2.4. Methods

The aim of the paper is to recognize the audit pitfalls in the audit of the non-current assets of the municipality. This section lists the pitfalls and suggests audit procedures how to avoid them. Process of audit of financial statements consists of several phases. These phases we could specify in framework as follows:

- Work carried out before the conclusion of the contract. At this stage auditor assesses the risks of the contract and set up the conditions of the contract.
- Preliminary planning activities include acquaintance with the client's business. It includes acquaintance with the control system and accounting system, and performing of preliminary analytical activities.
- Setting the audit plan covers the determination of the level of materiality for planning and risk assessment. Part of this stage is planning of tests of internal control and planning of substantive tests.
- Work carried out during the audit covers tests of reliability of systems. It also covers substantive analytical procedures and tests of details. This stage ends with evaluation of the results of substantive procedures.
- Conclusion and audit report release consists of the evaluation of the financial statements, and evaluation of the follow-up events. After acquiring of the declaration of the management and summarization of conclusions of the audit, auditor can prepare audit reports.

2.5. Problem solving

The auditor should know the common audit pitfalls that could appear during audit planning and performance. Pitfalls could be characterized as follows:

- First pitfall is lack of auditor's objectivity and independence.
- Second pitfall is recognizing of transactions with related parties.
- Third is poor identification of audit risks.
- Fourth comprises poor linkage between assessed risks and the nature, extent, and timing of audit procedures.

- Fifth means failure in proper designing and performing of appropriate audit procedures.

In the following subsections we set up procedures to avoid of recognized audit pitfalls.

2.5.1. Initial audit planning

Initial audit planning involves four things, all which should be done early in the audit. First, the auditor decides whether to accept a new client or continue serving an existing one. This is typically done by an experienced auditor who is in a position to make important decisions. Second, the auditor identifies why the client needs the audit. This information is likely to affect the remaining parts of the planning process. Third, the auditor obtains an understanding with the client about the terms of the engagement to avoid misunderstandings or pitfalls. Finally, the staff for the audit is selected, including any required audit specialists (Kareš, 2015). The base objective for the auditor at this stage is to inquire about the terms of the contract and determine whether the audit process will be in accordance with all laws and standards. Incorrect acceptance or rejection of the contract can have serious effects on the course and outcome of the audit and to issue the auditor's report and therefore on its reputation (Kašiarová, et al., 2015). The auditor of the financial statements of the higher territorial unit, municipality or city is obliged to check the use of repayable sources of financing according to the rules, to check the development and status of debt, to check management and other financial resources, and also to check the compliance of the management of budgets and laws relating to financial regulation for local authorities (Brániková, et al. 2011).

2.5.2. Preparation of the audit plan

Kareš (2010) claims properly planned audit with good strategy the auditor ensures assumptions that the audit will be carried out effectively and in accordance with International Standards on Auditing. During the formation of an audit strategy which shall include the timing of, the substantive scope and method of management audit, the auditor uses some groups of procedures. First procedure is assessment of factors that are important to the auditor during audit management, such as the use of internal audit, or entity's equity participation in the establishment of the organization. Second procedure is establishing the timetable for the various stages of the audit. Third is to determine the specifics of the audit during audit of the subject of public administration, respectively municipalities, and higher territorial units. Fourth procedure is to evaluate the importance of the information gathered during the preliminary activities.

2.5.3. Risk assessment procedures

The auditor uses knowledge gained from the understanding of the client's activities to identify and assess the risks of material misstatement that most arise to fraud or error in the financial statements. Because the auditor has to properly assess the risks of material misstatement, he must be thoroughly familiar with the subject and its internal control environment. Analytical procedures are also an important part of testing throughout the audit (Kašiarová, et al., 2015). The appropriate auditor's response on assessed risks is to acquire adequate and sufficient audit evidence regarding the risk of material misstatement, through the implementation of audit procedures. It means a test of the effectiveness of internal controls and use of substantive tests in verifying account balances and transactions.

2.5.4. Conclusion of the audit and the auditor's report

Auditor makes conclusions based on gathered audit documentation. Audit documentation is an essential part of every audit for effectively planning the audit, providing a record of the evidence accumulated and the results of the tests. The auditor must evaluate the situation when inappropriate and insufficient audit evidence was received or assesses the impact of material misstatement. Auditor should continually assess the sufficiency of audit evidence obtained through applied audit procedure. If the auditor concludes that the evidence is insufficient, he must procure a written declaration of the subject to support the confirmations of the findings of facts or to extend the sample of analysed realities, or to apply a substitute verification procedure. Conclusion of the audit relates summarizing of the findings during the audit, impact assessment of irregularities at the level of materiality, the confirmation of conformity of the relevant reporting framework with the financial statements, and written communications with the management of entity. The auditor forms his opinion based on an assessment of the facts arising from the findings of the audit. His opinion can be unmodified or modified:

- Unmodified (financial statements are prepared in all material respects in accordance with the applicable reporting framework).
- Modified (conditional opinion, negative or rejection of opinion) (Bràniková, 2011).

3. Discussion

Observed municipality is subject to statutory audit duties according to the Law on Municipalities. It has more than 3 000 inhabitants. The amount of assets exceeds 3 200 thousand EUR. We have established the basic audit procedures to audit of financial statements in order to fulfil the main goal of paper.

3.1. Acceptance of the contract

In order to accept the contract, upon the initial acquaintance with the municipality, must be answered the questions in Table 1. These questions assess the adequacy of acceptance of the contract. Auditor considers response on each inquiry. Correct answers to questions lead auditor to the avoidance of audit pitfalls.

Table 1: Risk assessment of accepted contract

	Evaluation of ongoing risk of contract	**Yes/No**
1.	Has auditor sufficient ability to manage client demands?	Yes
2.	Is accounting of entity conducted in accordance with law?	Yes
	Evaluation of ongoing risk of client	
3.	Has entity control or decision-making mechanism?	Yes
4.	There are no illegal activities of the management of the entity.	Yes
5.	There are no lawsuits against the client.	Yes
6.	There is no disclosure of petitions and complaints of citizens or of corruption scandals.	Yes
7.	Respects the entity laws regulators?	Yes

Unconditional requirements for performance of the contract		
8.	Did proclaim leading persons of the entity that are aware of their responsibility for the delivery of all the necessary information for preparing financial statements of the entity?	Yes
9.	Did proclaim leading persons of the entity that are aware of their responsibility for the correct implementation of internal controls?	Yes
10.	Did the management announce that the financial reporting framework is convenient?	Yes
Assessment of important ethical conditions		
11.	Does the auditor conduct sufficiently appropriate professional activities that meet professional standards?	Yes
12.	Have the auditor professional skills at the level sufficient to bring qualified professional client service?	Yes
13.	The auditor does not perform for the client other services.	Yes
14.	Court does not exist between client and auditor.	Yes
15.	Profit for the auditor for realized audit does not form a significant part of his income.	Yes
16.	The auditor does not belong to the leading persons of the entity.	Yes
17.	Long-term cooperation does not persist between client and auditor.	Yes
18.	No personal or family links exists between the client and the auditor.	Yes
19.	No business connection exists between client and auditor.	Yes
20.	Does not have the auditor a significant direct or indirect interest in the financial situation of the client?	Yes
May the contract on the audit be signed?		**Yes**

Source: own elaboration

3.2. Preparation of the audit plan

Due the fact the observed municipality is a small entity, we have implemented the appropriate audit procedures for testing types of transactions and events in the audited period; balances at the end of the period; and the presentation and disclosure. We have took take into account the management assertions of completeness (C), existence (E), accuracy (Ac) and appreciation (Ap), (see Tab. 2). The auditor's responsibility is to determine whether financial statements are materially misstated. An auditor decides early in the audit the amount of misstatements in the financial statements that would be considered material. Determining of the materiality level we set out the likely margin of error affecting users of financial statements. When the level of materiality is lower, the more needs audit testing. The Court of auditors recommends the value of 0.5 to 2%. Generally is used by 2%, thus this value has been chosen. As the basis for calculating of the absolute value was elected the total property amount, which we consider to be best suited to the nature of the entity.

Materiality in EUR = 2% of total assets

The total amount of assets in the municipality is over 3 200 thousand EUR. In this case, this means that errors above 64 000 EUR will be considered material.

According Arens et al. (2003), acceptable audit risk (AR) is a measure how willing the auditor is to accept that the financial statement may be materially misstated. Inherent risk (IR) means a measure of the auditor's assessment of the likelihood that there are material misstatements in a segment before considering the effectiveness of internal control. Control risk (KR) is a measure of the auditor's assessment that misstatements will not be prevented or detected by the internal control. Planned detection risk (DR) means that audit evidence for a segment will fail to detect misstatement exceeding a tolerable amount. Due to the fact that it is not efficient to collect all audit evidence to determine any differences and to have such 100% sure, we also decided based on the recommendation of the Court of auditors, to set 5% audit risk, which consists of inherent risk, control risk and detection risk.

$$AR = IR \times KR \times DR$$
$$DR = \frac{AR}{(IRxKR)}$$
$$DR = \frac{0,05}{(0,6x0,15)}$$
$$DR = 0,55$$

Detection risk means that auditor during the audits does not reveal deviations, and for which we determine the overall audit risk (5%), inherent (60%) and control risk (15%). The value of detection risk was calculated at 55%.

3.3. Setting of procedures and risks evaluation

Considering the limited scale of article we establish procedures for the audit only in area of non-current assets. During verifying of non-current assets (NA) it is not necessary to examine its undervaluation, it will be reviewed by other accounts (revenues from activation or purchase commitments), but it is important to detect errors which could lead to an overestimation of non-current assets (Kareš, 2010). Asset could be incorrect overvalued due their undervalued depreciation or disposals. When non-current assets are auditing, it is necessary to establish the existence of significant financial lease contracts and restrictions on disposal of property. Also, verify the existence, ownership rights (contracts of sale, documents) and property insurance. Summary of findings is in Table 2.

Table 2: Auditing procedure of non-current assets (NA)

	Auditing procedure	**Assertions**	**Findings**
1.	Reported NA items agree with the general ledger.	C, E	Yes
2.	Opening balances of NA ledger are the same as closing balances from the previous year.	C, E, Ac	Yes
3.	Changes in TA from the previous period are explained.	C, Ac	Yes
4.	Register with an initial value of NA, its cost, accumulated depreciation, and final value of items from the list of assets in use is conducted properly.	C, E, Ac, Ap	Yes

5.	An itemized list of additions at cost to date of putting into use and depreciation groups is free of material misstatement.	C, E, Ac	Yes
6.	An itemized list of NA decreases with the residual value, the method of disposal and sale price in the event of a sale of assets is free of material misstatement.	C, E, Ac	Yes
7.	An itemized list of accounts of assets in the acquisition process and advances paid for acquisition of property is free of material misstatement.	C, E, Ac	Yes
8.	Property rights with NA are verified.	E	Yes
9.	Existence of NA is verified.	E	Yes
10.	The cost of purchased NA agrees with supporting documentation.	Ac	Yes
11.	Purchases of NA are properly classified as capital expenditure.	E, Ac	Yes
12.	Disposal of NA has been approved, implemented and properly accounted for.	C, E, Ac	Yes
13.	Documents recording the loss of NA and liquidation reports, register of NA are properly maintained.	C, E, Ac	Yes
14.	An itemized inventory list of NA in the acquisition process agrees with the general ledger.	C, E	Yes
15.	Documentation of the existence and valuation of NA is correct.	E, Ap	Yes
16.	NA in testing is not used or depreciated.	Ac	Yes
	Account balances of non-current assets in the balance sheet gives a true and fair view.		**Yes**

Source: own elaboration

It is necessary to verify in the following procedures that:

- Non-current assets purchased by municipality are properly valued at cost for which the assets were acquired and the costs related to their acquisition.
- Non-current assets created by entity are valued at own costs.
- Non-current assets acquired free of charge are valued at fair value.
- Depreciation method of non-current fixed assets is identical to the depreciation plan.
- Change in accumulated depreciation is related to the amount of annual depreciation.
- Differences in accounting are explained by relevant person.

3.4. Summarization of auditor's evidence, conclusion of the audit and the auditor's report

Observed municipality has a functioning internal control system. The main controller of the municipality carries out continuous control under the Act on Financial Control and Internal Audit. The activity of the municipality is during the year also controlled by the municipal council. During the audit of the individual financial statements of

observed municipality in 2015 were identified no material deficiencies in the accounting system. The entity complies with the accounting rules and accounting policies and applies them consistently. All financial documents such as general ledger, all statistical reports, the book of incoming invoices, book of sent invoices, lists of each items, cash book, diary and others, fulfil all the formalities in accordance with the Law on Accounting. For all items was verified continuity of transfer of closing balances from previous financial year for the initial balances of the period under review. Closing balances were reviewed physical and book inventory and then compared with the ending balances to the general ledger. Individual transactions were correctly valued, recognized and classified. There were no significant misstatements. Changes in individual items compared to last year were sufficiently explained. On the basis of the audit procedures and findings resulting therefrom, it can be stated that the items of non-current assets in the balance sheet provide in every case true and fair view on subject of accounting.
During the audit were not identified any trends suggesting fraud in the entity and also has not identified circumstances or events threatening the ability of an entity to perform continuously its activities.
During the audit, some errors were found which not deemed material, but we recommend municipality to correct them in the foreseeable future:

- For a number of invoices it is not clear who the inventory ordered, we found missing orders, and also lacking the purpose of ordering. We found missing signature on receipts by competent persons who took the inventory delivery. We also noted the absence of approval from a superior officer for payment of invoices.

Recommendation: to add the purpose of the order to invoices, indicate the person the inventory ordered, as well as the approval of superiors for the payment of invoices.

- Missing assignment the budgetary chapter on the cash expenditure receipt when payment of invoices in cash, since the expenditure was charged before posting invoices.

Recommendation: except for incorrect posting there is a problem to determine in advance sufficient cash to be able to cover such unforeseen expenditure; we propose the complete cancel of payments of invoices in cash.
Based on the findings resulting from the audit procedures performed, we concluded that the auditor may issue an unmodified audit report without reservation.

3.5. Solving audit pitfalls in area of non-current assets of the observed municipality

After audit planning and setup of procedures, the auditor may conclude that audit pitfalls in the area of non-current assets were recognized and solved. We can summarize the auditor's considerations and solutions in the following Table 3.

Table 3: Solving audit pitfalls in area of non-current assets

	Audit pitfall	**Solution**
1.	Lack of auditor's objectivity and independence.	Positive answers 11.-20. on inquiries from Tab.1
2.	Recognizing of transactions with related parties.	Positive answers 4.-7. on inquiries from Tab.1

3.	Poor identification of audit risks.	Recognizing audit risks, set up level of materiality
4.	Poor linkage between assessed risks and the nature, extent, and timing of audit procedures.	Correct set up auditing procedures from Tab.2
5.	Failure in proper designing and performing of appropriate audit procedures.	Recognizing audit assertions from Tab.2

Source: own elaboration

4. Conclusion

The main objective of this paper was setting methods for the audit of non-current assets with aim to reduce audit risks and audit pitfalls. Process of the audit work can be divided into five phases, which consist of acceptance of the contract, formulating of strategy and audit plan, procedures of risk assessment of audit, summarization of evidence, and the auditor's report. Each section contains one specific audit procedures to be carried out to obtain the sufficient appropriate audit evidence to formulate findings, which are part of the audit documentation, based on which the auditor formulates its opinion.

Audit of the financial statements of the observed municipality in 2015 consists of an acquaintance with the functioning of the municipality, its control and accounting system, then, after considering the factors for acceptance, acceptance of a contract. After signing the contract was made a plan and audit strategy comprising calculating audit risk, materiality and audit plan. Due to the limited extent of the contribution were documented audit procedures in area of non-current assets.

The final part of the paper includes a summary of audit findings and recommendations drawn up for the municipality. This part contains proposals to solve audit pitfalls in area of non-current assets. During the audit were not disclosed significant irregularities, so the recommendations for municipality dealt with replenishment of missing cash receipt, cancellation of invoices for reimbursement in cash and amendments purpose of the order, the identification of person required to present the inventory delivery, as well as the approval of superiors for the payment of invoices. On the basis of the audit procedures and findings derived from them, the auditor may issue an unmodified audit report without reservation.

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