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### **ROLE OF AUDIT IN MANAGING PUBLIC INTEREST ENTITIES**

**Abstract.** The article discusses current issues of interaction between external auditors and management of public interest entities with the aim of making managerial decisions aimed at ensuring the continuity of an entity, ensuring balance between resources and their sources, eliminating distortions in financial statements.

Based on the study, it has been found that the definition of «public interest» is inextricably linked with the economic benefits of interested financial statements users. Internal control (audit) is aimed at prompt response to negative effects of economic activity. Considering financial performance generally, external audit provides users with reliable information on financial and property status of the audited entity, its financial results, and changes in cash flow and equity. Management team of a public interest entity has to create an audit committee to interact with an external auditor. At the same time, an external auditor creates an additional report and informs the audit committee on the applied principles of independence, on the key partner, on the auditors involved, on the scope and timing of the statutory audit, on the audit methodology, the materiality level chosen for the audit, on business continuity of the audited entity, on the shortcomings of its quality control system, on identified violations of the law, and on the interaction of auditors and management during the audit. A letter from the auditor to those with the highest managerial authority also contains information about the internal control system and its ability to identify deviations from legislative norms. A final document informing report users on financial and property status, operating activity, cash flow and equity statements of the audited entity is an audit report, which may include the following opinions of an auditor: unqualified opinion, qualified opinion, adverse opinion, and disclaimer of opinion. The management of the audited entity makes decisions on adjusting internal control system, financial statements, and revealed deviations from legislative norms based on audit documents preceding the report and the audit report itself. The procedure for adjusting the customer's internal control system of the audit, its financial statements identified during the inspection of deviations from existing legislative standards on the basis of audit documents preceding the audit report and an additional report for the audit committee of the enterprise is considered.

**Keywords:** public interest entities, audit, financial statements, audit committee, audit report, management.

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## РОЛЬ АУДИТУ В УПРАВЛІННІ ПІДПРИЄМСТВАМИ СУСПІЛЬНОГО ІНТЕРЕСУ

**Анотація.** Розкрито актуальні питання взаємодії між зовнішніми аудитором і менеджментом підприємств, що представляють суспільний інтерес з метою ухвалення управлінських рішень, спрямованих на забезпечення безперервності діяльності підприємств, балансу між ресурсами і джерелами їхнього утворення, усунення викривлень фінансової звітності. На основі дослідження визначено, що «суспільний інтерес» нерозривно пов'язаний з економічними вигодами зацікавлених користувачів фінансової звітності. Досліджено місце та функції внутрішнього і зовнішнього аудиту та розкрито їхні сутнісні характеристики. Доведена необхідність створення менеджментом підприємств суспільного інтересу аудиторського комітету для взаємодії із зовнішнім аудитором. Висвітлено рекомендації щодо надання зовнішнім аудитором до аудиторського комітету інформацію у формі звіту про застосування принципів незалежності, ключових партнерів, залучених аудиторів, обсяг і терміни виконання завдань стосовно обов'язкового аудиту, про методику перевірки, визначену суттєвість, перспективу безперервності діяльності суб'єкта господарювання, недоліки системи контролю якості, виявлено порушення законодавства, взаємодію аудиторів та менеджменту в ході перевірки. Обґрунтовано, що для здійснення комунікацій аудитора і менеджменту потрібне надання листа менеджментові, де аудитор сповіщає тих, кого наділено найвищими управлінськими повноваженнями щодо системи внутрішнього контролю та її можливості реагувати на відхилення від чинних норм законодавства. Розкрито вимоги до аудиторського звіту, який надає користувачам інформацію про фінансово-майновий стан, результати діяльності, рух коштів, капіталу і містить позитивну думку аудитора або думку із застереженням чи відмову від висловлення думки. Розглянуто порядок коригування системи внутрішнього контролю замовника аудиту, його фінансових звітів, виявлених під час перевірки відхилень від чинних законодавчих норм на підставі аудиторських документів, що передують аудиторському звіту та додатковому звіту для аудиторського комітету суб'єкта господарювання.

**Ключові слова:** підприємства суспільного інтересу, аудит, фінансова звітність, аудиторський комітет, аудиторський звіт, менеджмент.

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**Introduction.** The Law of Ukraine «On Accounting and Financial Reporting» enriched management with a new definition — «public interest entities». Public interest entities include: issuers of securities which are admitted to exchange trading, banks, insurance companies, non-governmental pension funds, other financial institutions (except for other financial institutions and non-governmental pension funds related to microcompanies, and small companies) and companies

that, in accordance with this Law, belong to large companies [1]. Users of financial statements of public interest entities require its managers to provide credible and reliable information on the financial condition of a business entity, its liquidity, solvency, business activity, profitability, income and expenses, cash flow, equity status, and other information, including corporate governance status information. The credibility and reliability of the information is confirmed by an independent audit. In turn, the adoption of the new Law of Ukraine «On the Audit of Financial Statements and Auditing Activities» brought the Ukrainian audit closer to international requirements and standards [2]. Thus, Directive 2013/34/EU of the European Parliament and of the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings requires the harmonization of national standards regarding the presentation and content of annual financial statements and reports on company management. Directive 2006/43 /EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts sets stricter requirements, firstly, for the independence of external auditors and application of the principle of professional skepticism by them, secondly, for the content of the audit report, and thirdly for the control of audit activity, including entities that audit financial statements of public interest entities, fourthly, for consideration and prevention of conflicts of interest [3].

**Research analysis and task setting.** Issues of external independent audit are considered in the works by the following scientists and practitioners: S. Bychkova, A. Sheremet, V. Suits, I. Belikov, V. Verbitsky, E. Petrik, A. Redko, N. Korinko, V. Bondar, I. Dmitrenko, N. Proskurina, Yu. Pogorelov and others. But the convergence of Ukrainian and European legislation requires auditors to make new decisions towards ensuring the activities of their customers, primarily foreign investors. The aim of the study is to disclose the features of applying the norms of European and Ukrainian legislation in the sphere of auditing financial statements of public interest entities, and to disclose the role of external audit in decision-making by business entities' management.

**Results and discussion.** Audit of financial statements is an audit service that verifies accounting data and indicators of financial statements of a business entity, including consolidated statements, with the aim of expressing an independent opinion of an auditor on its compliance in all essential aspects with the requirements of accounting provisions (national and/or international) [8].

The reasons for the need for such services are as follows:

- the need for stakeholders in the reliability of the information presented in financial statements of business entities, including public interest entities;
- the lack of specialized knowledge and practical experience in accounting among the stakeholders; the lack of necessary information and free access to primary documents of a business entity;
- subjective opinion of financial statements compilers and ambiguity of interpretation and application of normative and legislative acts by them.

Stakeholders of audit reports are:

- owners and investors, both real and potential (in terms of receiving dividends, share of profit and other interest income);
- creditors (suppliers who receive payments for delivered goods, works and services);
- debtors (in terms of obtaining the necessary goods, work, services and finished products);
- management of business entities (making current and future managerial decisions);
- state regulatory authorities (in terms of paying taxes, fees and permits, supervision of activities).

Public interest entities, primarily those that attract borrowed funds, are responsible to creditors for the return of funds and payment of interest income. It should be noted that the legislation defines «public interest entities» without focusing on what constitutes public interest. In this regard, literary sources have been analyzed, (*Table 1*).

Table 1

## The Definition of «Public Interest» in Literary Sources

Source	Definition of «Public Interest»	Note
Politics. Explanatory dictionary. — M.: «INFRA-M», Publishing House «Ves Mir». D. Underhill, S. Barrett, P. Burnell, P. Burnham, and others. Ed. by: Doctor of Economics I. M. Osadchaya, 2001 [4]	Public interest: 1. The general interest of individuals acting as members of a public group (public). 2. The totality of generalized individual interests of people affected by politics or some action.	There is an obvious difference between these two definitions, since there is a difference between a common interest and a combination of individual interests. A common interest is a shared interest, while the totality of individual interests depends on the final assessment of the position of individuals considered in isolation from each other. Such skepticism has found strong support in the theory of public choice.
Political science: dictionary — reference book. Auth. and comp.: I.I. Sangarevsky. 6 <sup>th</sup> ed, rev. and add. Tambov. 2016. [5].	The interest of any person (s) related to the well-being, stability, security and sustainable development of society.	Public interest is represented as the interest of society (common humanity)
Economy. Explanatory dictionary. — M.: «INFRA-M», Publishing House «Ves Mir». J. Black. Ed. by: Doctor of Economics I.M.Osadchaya, 2001 [6].	The only good for society as a whole, in contrast to the interests of individuals or firms that make certain decisions.	Instructions for managers of state-owned enterprises or for bodies called upon to regulate monopolies often contain phrases such as «to act in accordance with public interest». Due to the lack of any objective method for determining public interest, those giving such instructions should necessarily use their own opinions or refer to experience of similar organizations.
Large Dictionary of Foreign Words. — Publishing House «IDDK», 2007 [7].	An event that causes a common interest, profit or benefits	Public interest is connected with financial result of an activity

Source: Compiled by the authors [4—7].

Thus, in terms of entrepreneurship, public interest is directly related to economic benefits for all users interested in the activities of an entity [9].

Public interest entities are a system of interaction between their owners, managers, investors, and regulators [10]. In this regard, audit is considered as an integral part of this system.

From general economic perspective, management of a business entity is the process of influencing a certain object in order to achieve its objectives. The goal of any entity is the implementation of its mission, defined by a company's management, through profit. In order to achieve this, the entire managerial complex is considered as two interacting subsystems: the managerial and the managed ones. The managerial subsystem includes the work of senior managerial personnel in developing strategic plans, managerial personnel in the development and implementation of current plans for the production of finished products, goods, works and services, including organizational tasks for the supply of material assets, providing human resources, accounting and control (planning; organization; motivation; control; coordination). The managed subsystem produces products, goods, works, and services using available resources. Managerial personnel record deviations from planned indicators and then appropriate decisions are made.

Slightly different processes take place during external audit of financial statements: an auditor identifies deviations in the balance sheet, income statements, cash flow statements, and equity statements from the data in accounting registers and primary documents. Audit results are reported to the company's managerial personnel in the following documents:

- a letter to management;
- an audit report if the revealed deviations are comprehensive and significant (modified audit opinion).

The legislation also requires the submission of an audit report to an audit committee. The audit committee is the link that ensures interaction between the management of business entities and

audit firms. The committee conducts a competition to select audit firms to perform the auditing tasks. The proposals submitted by companies are evaluated according to the established selection criteria. After an audit firm has been chosen, the audit committee provides reasonable recommendations on its choice. At least two proposals from audit firms should be submitted before the mandatory audit of a company’s financial statements takes place.

The audit company’s report to the audit committee should disclose the results of the the mandatory audit and contain information with explanations on key issues presented in Table 2.

Table 2

Information for The Audit Committee, Which Is Submitted by The Auditor

Report Content	Explanations
1) declaration of independence	independence of conduct; independence of auditors’ opinion (indicating audit procedures to confirm independence)
2) identification of a key partner and auditors	full name of a key audit partner (partners) and auditors who are involved
3) disclosure of information on the involvement of contractors (co-executors) in the audit and confirmation of their independence in relation to the audited entity	information on the involvement of external experts (appraisers, tax consultants) and subjects of audit activity (indicating audit procedures for confirming independence)
4) data on cooperation and exchange of information with the audit committee and with representatives of the governing body of the audited entity	minutes of meetings and sittings, including dates and a list of issues discussed
5) information on the scope and timing of the mandatory audit, on the resources involved, including the distribution of tasks between the subjects of audit activity when they are involved; a description of the work performed by a foreign auditor involved (if any)	list of verified financial information, audit dates, area of responsibility of the audit firms and entities involved in the audit
6) disclosure of information on the applied methodology for checking financial statements; description of the valuation methods used for various groups of assets and liabilities	the applied audit procedures, indicating significant deviations in the financial statements compared to the previous year, even if the audit tasks were carried out by another auditor in the previous year
7) materiality level chosen for the execution of mandatory audit of financial statements	the level is given both as a whole, and in relation to certain classes of transactions, financial reporting items and other disclosed information; it also provides qualitative factors that are taken into account when determining materiality level (the share of an item in the balance sheet currency, the structure of sales revenue and other factors)
8) information on the continuity of the audited entity	auditor’s judgments on the identified events or circumstances which may lead to serious doubts regarding the ability of the audited entity to continue its activities on an ongoing basis; possible ways to ensure business continuity
9) information on identified significant deficiencies in internal control system and/or accounting system	it is pointed out whether the deficiencies that are identified in the internal control system of the audited entity are eliminated or not
10) information on identified facts or reasonable suspicions of law violation	identification of risks related to law violation and determination of their impact on financial statements
11) information on the consolidation of financial statements	disclosure of criteria for not including subsidiaries in consolidation
12) information on providing auditors with all necessary information explanations and documents to their inquiries; notice of significant difficulties encountered during the mandatory audit of financial statements	activities of officials of the audited entity regarding documentary support of the audit of financial statements

Source: Compiled by the authors.

The content of the letter to the management of the company shall meet the requirements of ISA 260 «Communication with Those Charged with Governance». An external auditor shall indicate the following information in a letter:

1. how much financial and non-financial information was checked, whether the planning of the audit took into account the specifics of the activity of the audited entity and the structure of its internal control in order to determine audit procedures;
2. significant drawbacks of internal control system and ways to improve it;
3. deficiencies in accounting and tax accounting and risks associated with distortion of financial reporting.

A letter to those charged with governance is prepared solely for informing the management, as well as other responsible officials of the audited entity, and cannot be used for any other purpose except for internal purpose; it is forbidden to make public references to the information contained in this letter without prior written approval from the audit firm. An extract from such a letter that was compiled by the authors, is given in *Table 3*.

Table 3

**The Letter From the Auditors to the Management of the Audited Entity (Excerpt)**

<p>Content of the letter:          Introductory part          System of internal control          System of accounting and tax accounting          Conclusions on the functioning of systems</p>
<p>Introductory part          We have conducted an independent audit in accordance with the requirements of the law, International Quality Control Standards, Auditing, Review, other provision of assurance and related services. These regulations require that the planning and conduct of the audit are aimed at obtaining reasonable evidence that there are no material errors in financial statements.</p> <p>During the audit, studies have been performed using testing to substantiate the amounts and information that are represented in the annual financial statements. Apart from that, an assessment of the conformity of applied accounting principles in accordance with International Accounting Standards has been made, formation principles of significant balance sheet items and reporting in general have been considered.</p> <p>Guided by our own experience and knowledge of the customer's business and having applied relevant methods of audit risk assessment, we believe that there has been an average audit risk during the audit. This audit risk assessment has been used for audit planning.</p> <p>The scope of our audit has not been limited.</p> <p>There have been no attempts to misinform the auditors or mislead them by the administration of the Institution.</p>
<p>Conclusions on the functioning of systems          The accounting system of the Institution can serve as a basis for the preparation of financial statements. In 2018, the Institution's accounting system provided regular collection and processing of the information necessary for the preparation of financial statements.</p>

Based on the information contained in the letter, the management personnel makes a decision on adjustments to the control system and financial statements.

The final document informing all stakeholders (management, investors, regulatory authorities, customers, and suppliers) about financial and property status, operating activity, cash flow and equity statements of the audited entity is the audit report. For public interest entities, legislation requires disclosure of additional information in the audit report, Table 4.

Table 4

## Additional Information in The Audit Report for Public Interest Entities

Report Content	Explanation
1) the name of the body that appointed the statutory auditor; date of appointment and duration of total uninterrupted engagement	management, owner, regulatory authority or other authority
2) audit risk assessment	an auditor represents: - a description of the most significant assessed risks of material misstatement in consolidated financial statements, including due to fraud; - reference to the corresponding reporting item or other disclosure of information in financial statements (consolidated financial statements) for each description and risk assessment of a material misstatement of information in the statements; - a brief description of the measures taken by an auditor to resolve such risks; warnings to management and other stakeholders regarding identified risks
3) an explanation to what extent the statutory audit was considered capable of detecting irregularities, including fraud	modification of the auditor's opinion: qualified opinion (there are minor misstatements of financial statements), adverse opinion (there are significant misstatements of financial statements), disclaimer of opinion (an auditor has not collected enough acceptable evidence regarding reliability of financial statements)
4) confirmation that the audit opinion is consistent with the additional report to the audit committee	See <i>Table 2</i>
5) a declaration that the prohibited non-audit services (NASSs) were not provided and that the statutory auditor remained independent of the audited entity in conducting the audit; indication of any services, in addition to the statutory audit, that were provided, and which have not been disclosed in the management report or financial statements.	the ban on the provision of a number of non-audit services by auditors of public interest entities, while the restrictions are more stringent than those stipulated by the Code of Professional Ethics of Accountants, which guides auditors in conducting audits in accordance with International Standards on Auditing

*Source:* Compiled by the authors.

The measures listed above largely correlate with the requirements that were introduced in EU member states as part of the Audit Reform in 2016.

As a result of the problems identified in the course of the audit of economic activities of the audited entity, the management and stakeholders of the audit report make managerial decisions that are aimed at improving financial performance. This process is carried out by revising and adjusting business plans, minimizing losses and the effects of force majeure events, combating fraud, managing all types of resources effectively, and improving internal control system.

**Conclusions.** The study highlights the following conclusions:

— audit services to verify financial reporting are in demand by stakeholders and are aimed at protecting their interests;

— the definitions of «public interest» and «public interest entities» are directly related to the economic benefits of users;

— internal control is aimed at prompt management response to negative economic phenomena; an external independent audit allows us to assess the ability of a company to operate continuously for at least a year after the balance sheet date, to identify the imbalance between a company's resources and their sources, distortions in financial statements; for this purpose, an external auditor creates various kinds communications with the management of an audited entity: an additional report to the audit committee, a letter to management and an audit report; information in these reports facilitates the adoption of necessary managerial decisions.

Further research will be aimed at the formation of working documents for the audit of financial statements of public interest entities.

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