

# Internal Audit of Estimated Reserves and Liabilities as a Diagnostic Method for Corporate Risks

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**Abstract.** Under the conditions of international economic and political instability, corporate risks exacerbate. Reserve funds and resources in the businesses on the basis of estimated reserves and liabilities are one of the risk management tools, that in their turn have quite a high level of variability as they largely depends on the current accounting policy and a professional opinion of an accountant. This influences significantly the development of financial indicators for commercial organisations, and serves as an additional corporate risk, Among others such as fraud. The conducted research explores the methodological toolkit of internal risk audit that is associated with estimated reserves and liabilities in commercial organisations. Scientific results are aimed at the creation of a corporate identification and control system for corporate risks with the help of estimated reserves and liabilities. Methodological recommendations on accrued expenditure allow to identify risks of inefficient costs, including fraud. The results of the research with empirical materials that were accumulated during the test of internal risk audit method associated with the creation of estimated reserves and liabilities in industrial organisations, audit companies, and in R&D at Plekhanov Russian University of Economics.

## 1. Introduction

According to the research done by PriceWaterhouseCoopers, in 2018 almost 66% of Russian organisations faced financial violations, including accounting fraud, which is significantly more than in 2016 with 48% [1]. Corporate, financial and non-financial accounting including information on estimated reserves, estimated liabilities and risks that are associated with their creation, which has been confirmed by the results of internal audit is an important informational and methodological instrument to enhance business transparency and control efficiency in commercial organisations [2].

This research includes the description of corporate risks internal audit using analytical control procedures for accounting invoices entailing increased risks, which allows to carry out control and at the same time to analyse the influence of estimated reserves and liabilities of the accuracy of performance indicators. In order to present the results of internal audit, types of accounting reports are

presented, risk identification and control methodological recommendations are developed, which will promote better control efficiency on the part of owners and investors.

## **2. Relevance and scientific research on the topic**

Corporate risks and their diagnostic methods were researched by such scientists as M.Bryukhanov, V.Kogdenko, Zh. Kevorkova, M.Melnik, R.Mukhametshin, V.Pankratiev, V.Pankov, R.Howard, E.Vallask, G. Zack, M.Comer, T. Wells Joseph, etc. [3-13]. The authors' research is aimed at the development of internal audit toolkit that is oriented towards commercial organisation risk control and management to enhance the sustainability and efficiency of the business [14].

The conducted research allowed to solve an important economic problem of the development of a new pertinent economic area in audit, associated with corporate risk internal audit. On the basis of the improved methodological approach to diagnostics and control of corporate risks, a new practical toolkit for internal audit of estimated reserves and liabilities was developed, that unlike the existing methods is based on control and analytical procedures with a view to identify indicators and auditees in the group of heightened risk, development and continuous update of the in-house corporate risk classification for estimated reserves and liabilities, the assessment of their influence on financial accounting.

The method of corporate risks internal audit with analytical control procedures for accounting invoices entailing increased risks, allows to carry out control and at the same time to analyse the influence of estimated reserves and liabilities of the accuracy of performance indicators.

## **3. Description of the objectives**

The research Developed a comprehensive approach to internal risk audit that is associated with estimated reserves and liabilities in commercial organisations. Publications on internal control and audit, periodic publications, norms and regulations, international standards of financial accounting, international audit standards and professional documents on the researched topics were used as initial sources of information [5]. The results of the research improve internal audit theoretical aspects as a method of corporate risk control and help to develop a methodological toolkit that ensures the implementation of the key approach to the content and composition of internal audit analytical procedures that control the accounting accuracy from the point of view of corporate risks using estimated reserves and liabilities and identify the influence of risks on performance of commercial organisations.

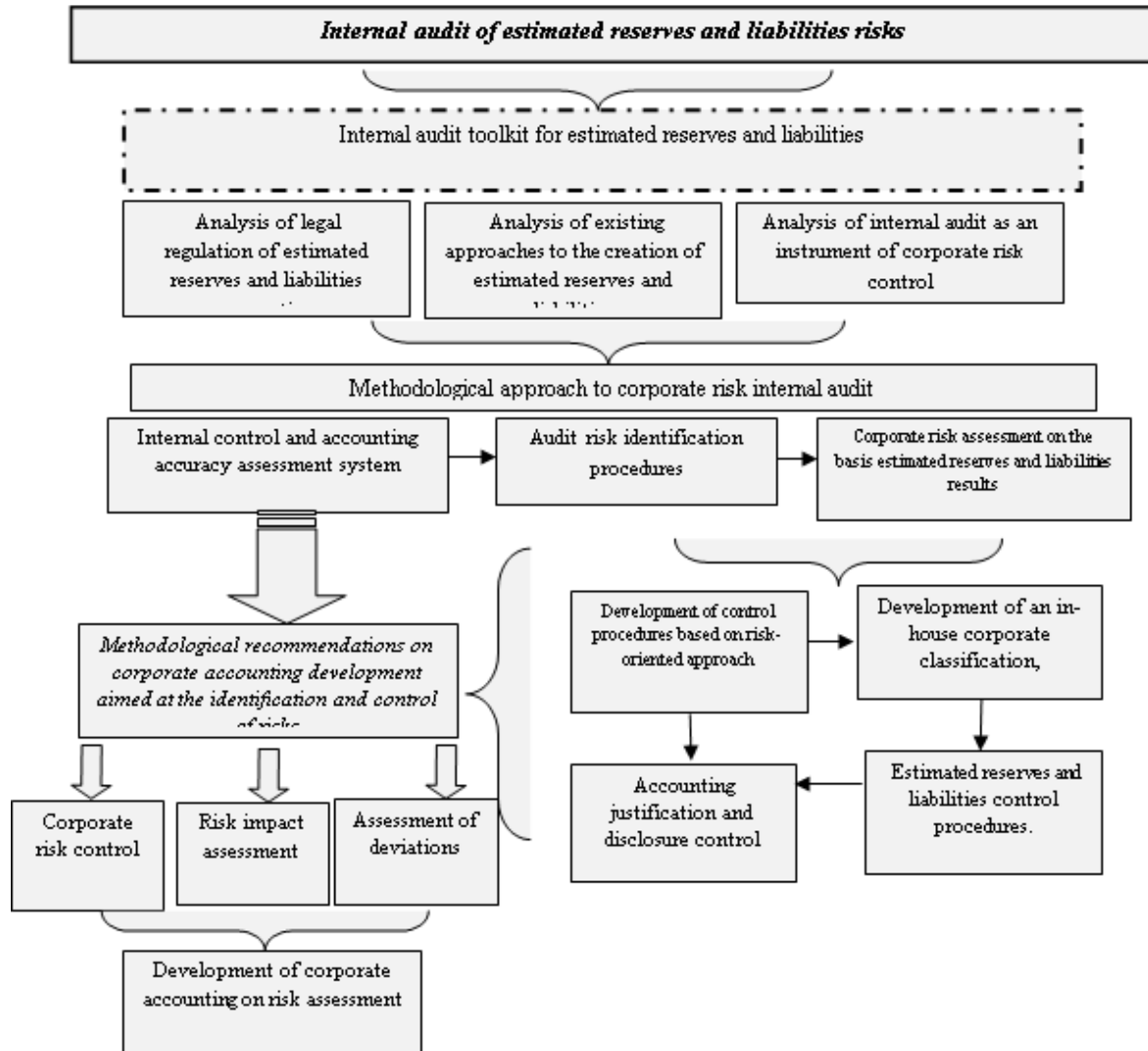
## **4. Theory**

The proposed methodological risk internal audit toolkit associated with the creation of estimated reserves and liabilities of commercial organisations is a complex system (Figure 1), which allows to control and verify the accrued expenditures by identifying risks of inefficient cost allocation, including fraud.

The creation of the estimated reserves and liabilities on one hand, is aimed at business risk accounting, and from the other hand, they serve as an additional source of corporate risks, as a tool to manipulate accounting reports, as they are highly variable, depend on the accounting policy in a company and a professional opinion of an accountant [15]. This is why internal audit of estimated reserves and liabilities risks is a control process on the part of owners that monitors their creation and influence on the performance with a view to assess the management efficiency of corporate risks caused by estimated reserves and liabilities. A classification of in-house corporate risks including the risks of fraud involving estimated reserves and liabilities is a methodology tool that serves as a navigator for internal audit procedure development.

The developed set of internal audit analytical procedures ensures the control of the most high risk accounting areas, accounting reports and in-house documents on the development of estimated reserves and liabilities and efficiency audit of expenditures on the their creation, which calls for a compliance audit to see whether expenditures on the estimated reserves and liabilities and accurate

description in accounting comply with the accounting policy in the commercial organisation [16-20].



**Figure 1.** A comprehensive system of internal audit of risks associated with the creation of estimated reserves and liabilities.

**5. Practical results**

The results of the research and empirical materials accumulated when the internal risk audit associated with estimated reserves and liabilities in commercial organisations were implemented in Lazurit-D, JSC. Extracts from the internal audit results are shown in the recommended report "Assessment of the impact of the estimated reserve for bad debts on financial performance" (Table 1).

The following results were received and summed up after an internal audit of accounts receivable estimated reserves: a deviation has been found that allowed to assess the influence of missing reserves on the financial performance; it has been established that the contribution of estimated reserve for bad debts in the balance sheet total in 2017 was 4.5%; in the accounts receivable it was 20.2%, and 28.8% in the net profits of the company, which shows the significant impact of estimated reserves on the net profit of a commercial organisation. What is more, the following types of corporate risks were identified: inaccurate information; errors in mathematical calculations; incorrect implementation of the accounting policy; unjustified size of estimated reserves; consistent and continuous inclusion of estimated reserves into expenditures of commercial organisations.

**Table 1.** Assessment of the impact of the estimated reserve for bad debts on financial performance.

Indicators	Row code	As of 31.12.17 without reserves for bad debts, thousand rubles	As of 31.12.17 with reserves for bad debts, thousand rubles	Absolute deviation , thousand rubles	Estimated reserve potential on the balance sheet total, %	The contribution of the estimated reserve into the total accounts receivable of a company, %	Contribution of the estimated reserve in the net profit of the company , %
Capital assets	1150	3 254	3 254	0	-	-	-
Reserves	1210	139,488	139,488	0	-	-	-
Accounts receivable	1230	42 477	33 914	- 8 563	4.5	20.2	28.8
Financial investments (excluding cash equivalents)	1240	3 863	3 863	0	-	-	-
Cash and cash equivalents	1250	1 197	1 197	0	-	-	-
Other current assets	1260	319	319	0	-	-	-
<b>BALANCE</b>	<b>1600</b>	<b>190,598</b>	<b>182,035</b>	<b>- 8 563</b>	<b>4.5</b>	<b>20.2</b>	<b>28.8</b>
Statutory capital (reserve capital, statutory fund, contributions of partners)	1310	100	100	0	-	-	-
Undistributed profits (outstanding losses)	1370	29 783	21 220	- 8 563	-	-	-
Borrowed funds	1510	8 463	8 463	0	-	-	-
Accounts payable	1520	152,252	152,252	0	-	-	-
<b>BALANCE</b>	<b>1700</b>	<b>190,598</b>	<b>182,035</b>	<b>- 8 563</b>	<b>from 1 to 5%</b>	<b>from 20 to 40%</b>	<b>from 20 to 40%</b>

Table 2 shows the proposed corporate risk identification and control system for estimated reserves and liabilities on the basis of the in-house corporate risk classification. The methodological recommendations on risk identification and control of estimated reserves and liabilities were developed on the basis of internal audit practices; it is a method that counteracts factors enhancing the possibility of error in accounting and reports.

**Table 2.** Corporate identification and control system for risks associated with estimated reserves and liabilities

The most high risk areas in accounting	Risk types according to the in-house corporate risk classification	Accounting fraud indicators	Consequences for the organisation	Methodological recommendations	
				on counteracting factors that enhance the possibility of error in accounting and reports	on risk information disclosure in corporate accounting
Reserves for stock depreciation	Risks associated with assets and liabilities costs Micro environment risks Accounting preparation risks	Deliberate non-use of material reserves, reserves that are idle for more than one accounting period	Reserve turnover reduction. Increased costs of estimated reserve development. Decreasing profit.	Corporate management code development, professional conduct compliance control. Production discipline control.	Disclosure of information on the risks is necessary to maintain assets and provide for full and accurate financial accounting
Reserve for bad debts	In-house corporate documents risks Accounting preparation risks	Accounts receivable on the basis of false invoices on goods, construction and services that will not be paid for during more than three years	Accounts receivable turnover reduction. It is impossible to compare the indicators for accounts receivable and account payable. Liability growth. Indebtedness growth. Overestimation of prime costs, lower profits	The organisation of control over new contractors.	It is necessary in order to use different corporate risk management methods
Estimated liability on annual leave	In-house corporate documents risks Accounting preparation risks	Fraud or lack of documents on annual leave of employees		Regular control over business processes in human resources paperwork	Information disclosure on estimated liabilities to control their creation and use

## 6. Conclusion

The practical tests of the research results allowed to develop methodological recommendations for internal auditors on information disclosure and on the assessment of the most important risks of corporate accounting in commercial organisations, which will promote better efficiency of business control on the part of owners and investors.

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