

The Implications of Inherent Risks' Assessment in Audit Risk Limitation

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Abstract: *In order to form an opinion regarding the quality of financial statements, financial auditors use certain procedures that allow them to obtain a reasonable degree of certainty that these are properly prepared in accordance with an accounting referential and give a true and fair view of financial position, performance and changes in financial position of entities subject to external audit process. These procedures, tests and audit reviews are done under conditions of risk those significant errors that could affect the quality of financial statements. In this respect, the auditor's mission is also to identify, assess and minimize the risks impact of material misstatement due to fraud or error.*

Keywords: *Financial audit, risks, inherent, control, detection*

Introduction

The degree of assurance the auditors on the financial statements give it is generally considered (depending on mission) high but never absolutely, given the limitation tests and other inherent limitations of the audit. Also, due to the inherent limitations of any system audit (inspection) internal risk is inevitable that some inaccuracies, although significant, is not found. When the auditor has evidence on which implies the existence of fraud or error that can lead to significant inaccuracies, it should extend its control procedures to confirm or refute his doubts. However, this approach does not prevent the materialization of risks distorting financial reporting.

1. Risk Factors in Financial Audit

Knowing the risk factors allows auditors to pay due attention to possible errors that may have an impact on the annual financial statements, an important part of planning work, allowing a more effective audit by targeting the areas where risks are the most likely errors. Specific audit checking focus on professionals needs to maximize the effectiveness and objectivity of their work. In practice this need has been felt through the influence of at least three factors: [2, p. 137]

- "personal factor" which involves optimizing the use of auditors in carrying out various works, usually they are quite readily available to meet all service requirements in this area.
- "requirements" - is the fact that more and more users of the information provided by auditors, such as State, shareholders (associates), banks, suppliers, customers and stock monitoring committees (COB in France, the U.S. SEC, SIB in the UK, CNVM in Romania), are becoming increasingly demanding about the quality audit, the auditors that the assurance given that there is very little risk of detection of an error.
- "cost" - customers not only require audit firms that paid fees be reasonable but rather they do not exceed what a competitor (or a group of independent auditors) may request the return of the same quality service.

Confronting with such internal and external pressures, auditors were forced to find a way of certifying financial statements to enable them to minimize the number of billable hours while increasing confidence in the quality of the information verified. To achieve such an objective, the auditor starts work through an activity of "training" the client, aiming his conviction that we must always maintain sufficient quality in its internal control system.

Thus, the auditor should provide operational advantages as arguments arising out of such an approach, while customers will be attracted to the possibility of lowering increasingly more fees you will pay, because if the company has a good internal controls this will reduce the number of working hours spent to discover eventual errors.

In this context, the control of objectives within a statutory financial audit is planned based on risk factors and their relative importance, which differ from one entity to another.

From the point of view of the exposure of the entities, risks have different probabilities to produce themselves, in theory there is a grouping of this potential risks and possible risks.

The *potential risks* are common to all entities and may occur if there is no control to prevent them. These risks are even given the existence of entities operating in different socio-economic backgrounds.

Possible risks are those potential risks against which entities do not have the means to limit, with a high probability of errors without their being detected or corrected. The existence of these risks would particularly the organizational structure, management companies, different means and resources they use etc.

In order to conduct an effective audit, auditors seek to identify possible risks in order to adapt control and evaluation of the incidence of errors on the annual financial statements.

Another approach of risks in terms of their incidence on an audit mission is the **audit risk**, a concept used for mission planning. **Audit risk** (AR) is a function of the significant misstatement risk and of the detection risk, its assessment being more a matter of judgment than an aspect that can be measured precisely. ISA 200 - General objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing (ISA) states that the risk of material misstatement (the statements) has in turns two factors: inherent and control risk. [4, p. 87]

In this situation, *audit risk* analysis is done on three components: [1, p. 208]

- inherent risk (the risk that a material misstatement could occur);
- control risk (the risk that the entity's internal control system to prevent or detect no errors);
- detection risk (the risk that material errors not identified by the auditor).

The **inherent risk** (IR) is a general risk that consists in the possibility of the appearance of significant errors given the particularity of the entity, its activities, its environment, the nature of the accounts and operations. These general risks, specific to entities, are all likely to influence all their operations, with implications for the audit process, by generating possible errors affecting the financial statements.

Each entity, depending on the sector in which it operates, its structure, size and organization, has its own characteristics which make more or less probable the realization of its potential risks. In order to control a company, the auditor should identify characteristics that distinguish it from others. Thus, one must investigate and analyze the following information:

- the business sector and the sector it belongs to - is essential for the auditor to know the objects of the company (production, service, trade, etc.), for evaluation problems, for example, are not absolutely identical. The auditor also will inform him/herself if the company is active in a sector booming or declining (risk of cessation of trading is different), if there are special regulations of the sector (purchasing, sales, financing, pricing, etc.)
- organization and company structure: control issues come different when a company belongs to a non-integrated group, when all activities are concentrated or dispersed in several locations, the company is well established organization and responsibilities are poorly set etc.;
- general policies of the enterprise: financial, commercial and social;
- development prospects of the enterprise: for example, if the company provides a rapid development, the auditor should pay attention to material and financial means necessary for this program, and if the outlook is pessimistic, the auditor will focus on business continuity issues;
- administrative and accounting: the existence of a system, there are administrative and accounting procedures, a system of budgetary control, the existence of a internal control affecting the organization and effectiveness of control;
- accounting policies of the enterprise: even before addressing its control, the auditor should ensure the accounting principles used and grounding their choice, at least for those items or feature points of the activity.

Based on previous information the auditor may consider its overall risk inherent in certain components, such as:

- *risks related to enterprise and its business environment* (size, products and markets, supply sources, operations in foreign currency, fluctuations in activity, the risk of non-recovery of claims, etc.)
- *risks related to capital structure* (existence of a shareholder or a majority one, the risk of the "manipulation" of the result);
- *risks related to financial structure* (lack of working capital, lack of equity, treasury management issues);
- *organizational risks* (lack of administrative personnel, weaknesses in information system);
- *risks related to the importance of balance sheet items* (those exceeding 10% of balance).
- *risks related to certain operations or accounts* refers to the possibility that certain accounts or operations be inaccurate. These risks are assessed, taking into account the following factors: nature of the data (repetitive, timely, exceptional), complexity of operations / accounting treatment, measurement difficulties, the estimation results of operations, and evaluation issues involved subjective elements or to the management estimates; transcription difficulties in accounting operations, taking into account the legal particularities etc.

To these it may be also added the risks linked to the economic situation of the enterprise (such as elements likely to discuss business continuity) or risk management related to attitude (the auditor will be given some attention in control when management is concern of choice for production and marketing and other attention when management is concerned with internal control problems and the quality of financial information).

The practical work of risk assessment is carried out by auditors in a planned stage of the audit, the section F1 (a file audit sections are numbered from A to P, Section F is called "audit approach" and the F1 section includes "Checking list of the generally inherent risk"). Assessment of inherent risk generally involves finding answers (positive or negative) to questions about management, accounting, and auditing the company's activity audited. Share answers "Yes" or "No" to all questions on each component of risk analysis allows classification of the categories of risk as VERY LOW, LOW, MEDIUM or HIGH, as shown in the example provided in Table. 1.

The general inherent risk assessment is carried out as a general average of each component of risks.[5, p. 78]

Table no. 1

The general inherent risk assessment list

	Yes	No
1. Management risk		
(a) Do managers lack knowledge and expertise to run the company?		No
(b) Have the mangers the tendency to engage the company in association with a higher risk?		No
(c) Did it happen to be changes of the managers occupying key positions during the financial exercise?		No
(d) Are there certain requirements to maintain a level of efficiency or the fulfillment of certain objectives? (for example to fulfill requirements from the part of the creditors)	Yes	
(e) Has the reported result a personal significance for the managers? (i.e. primes linked to the profit)		No
(f) Are the management control and the administrative one weak?		No
(g) Is there a lack of performing managerial informatics systems?		No
(h) Are the managers correctly involved in daily activities? (This question is relevant only if there is identified a risk at the above point (d) or (e).	Yes	
THE GENERAL ASSESSMENT OF THE MANAGEMENT RISK VERY LOW / LOW / MEDIUM / HIGH	LAW	
2. Accounting risk (AR)		
(a) Is the accounting function decentralized?	Yes	
(b) Are the accounts personnel lacking training and capacity to fulfill their tasks?		No

(c) Are there problems concerning the attitude or a low morality in the accounts department?		No
(d) Is there a risk to make errors as a result of the fact that the employees work under pressure?		No
THE GENERAL ASSESSMENT OF THE ACCOUNTS RISK VERY LOW / LOW / MEDIUM / HIGH	LOW	
3. The risk of the client's activity – Business risk (RCA)		
(a) Is the company developing the activity within a high risk sector?	Yes	
(b) Is there any creditor – tertiary part with an individual, significant importance?	Yes	
(c) Is there a concentration of actions or voting rights higher than 25% in the possession of some members of the Board of administration without an executive function?	Yes	
(d) Is there an anticipation that the company (or of it) could be sold in future?	Yes	
(e) Has the control of the company been taken away by someone else during the last 12 months?		No
(f) Is the company insolvent?		No
THE GENERAL ASSESSMENT OF THE BUSINESS RISK VERY LOW / LOW / MEDIUM / HIGH	HIGH	
4. The risk of audit activity (RAA)		
(a) Is for the first time that the company will audit this client?		No
(b) Is there an opinion expressed within the audit report with significant reserves as concerns the past two years?		No
(c) Would you describe the relationship with the company – client as being “in conflict” or in a “deteriorating condition”?		No
(d) Are there pressures linked to the fees or time?		No
(e) Is there a significant number of shares “difficult to be audited”?	Yes	
THE GENERAL ASSESSMENT OF THE AUDITING ACTIVITY RISK VERY LOW / LOW / MEDIUM / HIGH	MEDIUM	
THE ASSESSEMENT OF THE GENERAL INHERENT RISK	MEDIUM	

2. Control and Detection of Risk

Control risk is assessed during the assessment of enterprise control system. Control risk is the risk that internal control system does not ensure the prevention or the detection errors, it being a function of effective design, implementation and maintenance of internal control. Given this risk, any weakness in internal control system determines the transformation of a potential risk in a possible risk.

The control risk is closely related to the nature of operations of the enterprise. They generate three categories of data to be processed by the accounting system:

- repetitive data, resulting in regular business activity (sales, purchases, salaries, etc..) and which will be processed in a uniform manner;
- timely data that are complementary to repetitive, but every time appear unequal (inventory valuation at year end);
- exceptional data, resulting from business operations that do not currently perform (re - assessments, mergers, restructuring).

Risks can be reduced easier for repetitive data when designing systems is reliable. For example the possibility of discovering the altered stocks is much easier if the system adopted provides that any out of stock must be a document and that these documents should be subject to invoicing (cargo).

Even for companies with automated not very sophisticated data processing systems, repetitive data will be processed by the computer. In these conditions, important factors in risk control assessment are the accuracy with which they are designed and monitored the system of automatic data processing and quality software applications.

As the data points, they are carrying significant risks when they are not identified and registered in time. It is required that the auditor know beforehand to be able to organize controls.

Extraordinary operations bear risks not only linked to the lack of skill and experience of the personnel in processing them, but also of the possible lack of technical knowledge and lack of comparative elements.

To the control risk there can be associated a risk linked to the design and operation of the systems. The design of the discovery and treatment systems of the operations should allow the prevention or discovery of those errors which have occurred in order to correct them. Often, however, even if processing and control system designed for enterprise data is reliable, it may prove malfunctions if the forecasted internal controls are not performed.

Detection risk or the risk of non – discovering on the occasion of an audit is a risk proper to the auditor which consists of the fact that by not using substantive procedures, the latter is not able to detect the existence of a significant error within the balance of an account or in a category of operation, isolated or cumulated with wrong information from other balances or categories. The auditor's selection procedures, scope and date of intervention necessarily involves a certain level of risk, the auditor will need to reduce it more and more. It can not be eliminated, whatever auditing techniques and procedures and therefore whatever control system adopted by the enterprise, since it is not possible, especially for reasons of cost and effectiveness, to obtain an absolute insurance that in annual financial statements there are no errors.

General inherent risk assessment, of specific inherent risks, of the control risk and detection risk allow, based on statistical data tables, calculation of risk bands associated with sample sizes of elements to be verified by auditors during missions.

Given the link between the three components of audit risk and that their product ($RA = RI \times RC \times RD$) should be limited, the International Auditing Practices Committee (International Auditing Practices Committee - IICP) has established a matrix that allows acceptable detection risk assessment based on inherent risk and control risk as follows: [1, p. 210]

Table no. 2

		Control risk		
		High	Medium	Low
Inherent risk	High	Low	Low	Medium
	Medium	Low	Medium	High
	Low	Medium	High	High

It results from this table that there is an inverse relationship between the combined degree of inherent and control risk and detection risk level set by the auditor.

Conclusions

In conclusion, audit risk is that significant errors may exist in the annual financial statements and the auditor, no discovering them, makes a wrong opinion. He has yet to devise work program in order to obtain reasonable assurance that there are no significant risks in the annual financial statements and thus limit audit risk to an acceptable minimum level, apart from the preliminary risk assessment of inherent and control risk.

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