FINANCIAL AUDIT - RISKS IDENTIFIED IN THE AUDIT PLANNING STAGE

Lecturer Stelian Selisteanu, PhD
Lecturer Nicoleta Mihaela Florea, PhD
Associate Professor Radu Buziernescu, PhD
University of Craiova, Faculty of Economics and Business Administration
Craiova, Romania

Abstract: The general objective of the audit activity is to currently present, under all significant aspects, a financial situation and to state an opinion according to which all economic operations are indeed correct and pursuant the law. As any activity that involves the human factor, the audit activity is subject to the influence of certain risks, risks that emerge, firstly, from an organizational level of the audited entity. In audit, risk is a very important influence element, whose ignorance can generate major implications in achieving the final goal to create an evidences database on which a pertinent and objective opinion can be founded, concerning the audited financial situations. In this context, one of the main objectives, that takes place during the planning phase of the audit, is represented by assessing risks to which the audited activity is subjected to, evaluation that helps the determining the work volume implied by the audit.

JEL classification: M40, M42

Key words: audit risk; internal control, risk analysis, inherent risk, control risk

1. INTRODUCTION

In audit, the audit risk can be defined as the risk that an auditor to state an unqualified opinion when the financial situations contain material misrepresentations or a qualified or adverse opinion, when the expenses declarations do not contain material misrepresentations. In other words, it is represented by the probability of a situation created by the influence of certain elements that could determine the auditor to state an opinion that does not reflect the real situation of the analyzed activity, such as it was reflected in the accounting financial situations.

Lack of a risk analysis during the planning phase can generate a series of effects, initially less noticeable, but that could, thereafter, transforms in alternated information sources which, analyzed and utilized by the auditor, create the requirements for an erroneous opinion.

In these conditions, an initial evaluation of the risk level, specific for the audit activity, is compulsory, as a fundamental necessity of any audit mission.

The analyze and assessment of the risk level specific for the audit activity is a difficult operation, dependent on a great number of influence elements, most of them identified during the organization and functioning activity of the management of the audited entity.

The risk assessment process is a continuous exercise which, in the case of a periodical audit in the same patrimonial entity, is yearly updated, the necessity of such action consisting in: planning the audit activity, reducing risks by planning audit procedures as a response to the identified risks, increasing the audit efficiency by concentrating the audit process on high risks areas, selecting additional operations patterns.

A preliminary risk assessment, based on the inherent risk factors, is initially effectuated by the auditors to elaborate the audit strategies, taking into consideration the results of the preliminary assessment missions evaluating the conformity of the management and control system.

According to the previsions of the International Audit Standards and the European Commission's Guide for the audit strategy, risk assessment is a major phase in the audit process, which follows:

- to identify and to assess the configuration methods of the internal control system of the audited entity and the methods of implementing it;
- to identify and to asses potential risks in the entity and its processes;
- to asses if the internal controls of the audited entity can identify, prevent, eliminate or minimize risks;
- to assess the impact that potential risks could produce on the expenses declarations.

2. Risk components

The practice of the audit activity reveals the risk components, respectively: the inherent risk, the control risk (to verify and to analyze) and the non-detection risk.

The inherent risk represents the susceptibility that a material misrepresentation to interfere with the financial situations, individually or cumulatively, assuming that there are no afferent internal controls. The auditor will have to assess for each category of economic operations if the inherent risk is high, medium or low. In this sense, one will have to take into consideration o series of factors whose influence orientates the auditor's reasoning concerning the classification of the inherent risk in one of the three categories.

Thus, the nature of the entity's activity is a factor generated by the dimension of the entity and by the complexity of the activity. It is eloquent that an entity of small dimensions and with a simple activity can supply an inherent risk lower than a big dimensions entity and that carries a complex activity. This factor influences directly the organization of the internal control, which can enhance even more the dependence of the inherent risk's value to the complexity and methods of this control.

The nature of the economic operations is another factor which dimensions the inherent risk. In this sense, it is predictable that in auditing an entity that carries on the same type of operations and of the same intensity, the inherent risk to be low while, if the carried operations register a significant dynamics in short ranges of time, both as typology (nature) and as volume, the inherent risk tends towards medium or high values.

Among the factors influencing the inherent risk, we find unusual economic operations. Thus, there is a higher probability that the unusual operations of the entity, unlike routine operations to be recorded or processed incorrectly due to lack of experience. We illustrate here: leases, major acquisitions, losses calamities, etc. Knowledge of the entity and analyzing documents that give content management meetings (minutes, transcripts, etc.) Are useful methods for identifying and analyzing this type of operation.

Assets likely to be diverted, is one of the factors that may influence the inherent risk. In this context it is estimated that in the case of transactions involving cash payments or receipts, inherent risk is high, as when the likelihood of diversion of funds is higher, inherent risk increases.

Another factor meant to influence the limits of the inherent risk is the legal frame which regulates the operations subject to audit. In this context the inherent risk will increase in a complex, unclear or even contradictive legislation and will register minimal values in simple and clear regulations.

The experience and the formation of the personnel from the audited entity, as an influence factor of the inherent risk, acts preponderantly in the area of decision-making posts that either administrates the audited operations either carry internal control activities.

Also, an important factor is the measure in which the attributions previewed in the job description of the personnel are sufficient, applicable and easy to verify. Their formalism always prints on the inherent risk an ascendant direction.

Finally, the equilibrated fluctuation of the personnel of the audited entity is another factor that must be considered for assessing the inherent risk. In this context, we highlight that, on one side, a very active dynamics in this sense can lead to an insufficient experience, which could determine a high inherent risk, and, one the other side, a less active dynamics can activate also a high level of inherent risk because, such as practice has shown, the exacerbate continuity in carrying the same operations by the same employee can lead to the registration of some errors generated by the acquired habit which could determine either a drop of attention, either subjective arguments with an illicit character.

Beside the above named factors, it must be highlighted that the assessment of the inherent risk considers also the quality of the management system of the audited entity, which is analyzed by the auditor in terms of general main elements that influence directly the act of management, such as:

- the nature and object of the activity carried out by the audited entity;
- the fulfillment conditions of the main activities in the institution;
- the management experience of the personnel responsible with the entity's administration;
- the frequency of personnel modifications determined by its lack of experience;
- managers' reaction to various conjectural situations which could determine them to register into the financial situations some operations that do not correspond to the reality.

Implementing, by the managerial team, a modern accounting system for the activities that take place here, adapted to the own developmental conditions and utilizing it according to the legal previsions through which it was approved, represent important ways to reduce the inherent risk's level associated with the audit activity.

Assessing the inherent risk in the above mentioned context is realized through the following of the implementation of the systems belonging to the utilized accounting system, on an operations' scale that represents the object of the audited entity. The results of verifying the registrations methods, in time and at a real value, in the accounts opened for sampled operations, in such manner that the analyzed data not to become false information that could be used in synthesis financial situations, can be extrapolated at all operations' level, realizing an estimation, sufficiently representative, for the inherent risk value.

The main condition for that operation to enframe in a reasonable degree of certitude is that the sampling to be realized for representative operations and periods of the entity's activity.

The improper use of the general and specific principles of the accounting system can have as consequence creating a database whose information are not from the category of the ones necessary, real and pertinent, situation that could determine a high level of the inherent risk associated with the audit activity, with direct implications in the possibility of enunciating a wrong audit opinion.

Auditee:	Period audited:	Working Document Reference:	
Category of operations:			
Prepared by:		Reviewed by:	
Factors:	Indicates a low risk	Indicates a high risk	The risk assessment and reference to a document which says
Nature of entity activities	Small entity with a simple structure	Large entity with a complex structure	
Unusual transactions	Few or none	Numerous	
Estimates regarding the registration operations; use of professional judgment in determining certain values	Does not require a complex professional judgment	It requires a considerable professional judgment	
Susceptibility of active material fraud or theft	Fixed assets that cannot be removed	Readily marketable assets or valuable movables	
The combination and value of the items	Few articles with high values	Many items with small values	

Number of locations	The entity has one location	The entity has multiple locations	
Principle complexity	Simple	Complex	
Other risk factors (if applicable)			
Overall rating of the entity	High risk	Medium risk	Low risk

Analyzing the form presented above, it can be seen that the auditor should consider the following activities:

- to identify categories of operations in the financial statements to be tested
- to document the factors used in assessment of inherent risk
- to assess risk (low, medium, high) for each risk factors identified

Simultaneously, the auditor should consider whether there is a risk that the audited entity's financial statements to be errors. In this context, it will identify irregularities and / or material errors and whether this was done intentionally or not. Also, the auditor takes into account the cumulative risk of monetary errors may cause the entity to prepare financial statements misleading.

In the evaluation of inherent risk, the auditor must take into account the existence of the risk of corruption and money laundering. The risk of corruption arises in circumstances that offer civil servants the opportunity to grant licenses or exemptions selective priorities for the provision of public services or the possibility of discriminatory interpretation of rules or procedures manuals. The risk of money laundering can occur in any of the situations in which people make payments to public institutions and get back the money within a very short time.

After identifying specific risks, they should be recorded in working papers. At the same time, he will enroll both cause that led to the emergence of these risks, and the effect on accuracy, completeness and accuracy of the financial statements.

The control risk represents an error that could appear in a category of operations and which could be individually material, or, when is cumulated with other wrong information from other categories, to become impossible to avoid, detect or correct, in time, by the internal controls.

This type of risk reflects the degree of the audited entity’s internal control system’s consolidation and, more precisely, if this works efficiently for preventing or detecting errors or irregularities.

An internal control system comprises both the control environment and control procedures.

The control environment includes the concept of management and operational approach, establish responsibilities and procedures for control policies. In fact, where it proves ineffective control environment is unlikely to be effective control procedures, regardless of security which, apparently, it provides documents drawn.

Control procedures are the policies and procedures that management entity established to protect them against fraud on this, losses, irregularities and errors. They have a role in prevention, but also in detection.

Preventive controls are designed to prevent and stop the occurrence of errors especially in the accounts. They are either documentation (manuals of procedures) or involve specific control procedures applied to each operation.

Detection checks are carried out in order to discover and correct errors or irregularities in the accounts, and are usually more importance for the auditor compared with preventive controls because, normally, there is documentary evidence showing that such control functioned as intended which was given initially.

In control procedures category we find:

- management checks that are generated by management, which by their nature, based on supervision and review control procedures help to detect errors. They include non-inclusion checking reports and control how to exploit internal controls and performance results using budget appropriations.
- result from organizational controls how each organization is structured and can be both prevention and detection. They usually include but well-defined responsibilities and separation of incompatible functions such as initiating operations, processing and processing, recording.
- authorization controls that are in the category of preventive rule applies to the individual operations and aims to halt operations to be processed and which have not been authorized at the appropriate level. They set the volume necessary checks before approval, how they will be tested and finally checks "who" and "what" would approve.
- physical checks that have a preventive and include controls on access to goods and accounting records by simple physical protection measures (vault) and by logistic measures (electronic passwords).

It should be noted that no control system cannot fully ensure complete accuracy and correct registration operations. In this context, the auditor assesses control risk you must take into account a number of factors, as follows:

- the possibility that these checks should not be taken by those responsible for their execution.
- improper conduct checks due to human error as a result of a judgment or misinterpretations or due to negligence or carelessness.
- inability of standardized control systems to address unusual operations
- failure of control due to changes in processing operations and the adoption of inadequate procedures.

In practice, evaluating control procedures are based on a questionnaire that the auditor gives to completion to the entity. In preparing its auditor will ensure that it covers all controls aimed at reducing specific risks identified. It stressed that the auditor must select only those questions that are relevant to the audited entity.

Finally, understanding the audited entity with the aforementioned questionnaire used to assess control risk.

Assessing the control risk can be made in two steps: basic assessment and final assessment.

Basic (primary) assessment has the role to determine a prime level of the control risk and is effectuated based on studying some factors can could create risk generating elements and which, generally, refer to:

- the efficiency of the accounting systems and internal financial control in the preventing and detecting wrong information;
- the auditor’s capacity to assimilate accounting standards and internal financial control used by the economic unity, subject to audit;
- the auditor’s availability to effectuate some auxiliary control actions whose results to allow the motivation of the control risk, assessed in the primary assessment.

The control environment includes all actions and concerns regarding the functioning of internal controls the entity management and exploitation of results.

Control environment, largely determined by management policies and style of functioning of the entity, is fundamental to the proceedings of the checks in an institution. Therefore, to gain full understanding of the control environment, auditor should focus mainly on high-level policies and practices entity and heard a lesser detailed checks on individual operations. The auditor's understanding of the control environment requires the following to be considered:

- ethical values and integrity of management entity;
- establishment of objectives and knowledge management risks involved fulfilling their;
- operation of management style and organizational structure;
- establishment of variant management responsibilities (e.g. organizational structure and the separation of powers);
- management policies to maintain competent staff or recruitment policies and professional training;
- supervision of management control procedures and functioning accounting system, including reviewing and monitoring operations budget;
- how the management entity ensure compliance with laws and procedures.

If the auditor is not satisfied with the entity's control environment, it is likely that monitoring procedures do not work effectively in practice. Therefore there is no need for the auditor to evaluate individually control procedures because there are no differences compared to control risk assessment. Under these conditions the control environment questionnaire will be sent to the audited entity and auditors conclude assessment of control risk, establishing that it is high.

Note that the auditor should discuss with the management entity's control environment weaknesses and make recommendations to strengthen it. Also he will rely on these weaknesses in the formulation of recommendations for remediation.

If the auditor is satisfied with the quality of the entity's control environment, it creates the premise that control procedures work properly in practice, the auditor can evaluate if indeed they are carried out effectively.

Choosing and implementing some accounting and internal control systems, adapted to the economic unity's objectives, that could make possible the application of the standards to guarantee obtaining a base of legal, real, necessary and pertinent information, represent real conditions of diminishing the control risk's level in audit.

Manufacturing this information base represents actually audit proofs and create for the auditor a consistent data base, necessary for establishing real conditions of diminishing the control risk in audit.

Generally, the data registered in archives are from the category of those that answer to the auditor's objective, respectively the one to enunciate some real and pertinent opinions, since all accounting systems represent, in themselves, a control method of the information.

The accounting analysis is a compulsory activity realized in any accounting system, it is realized before and after the registration of the data in archives and represent, actually, a form of internal financial control, with a preventive character, which has as objectives establishing the legality, the reality, the necessity and the pertinence of the information.

The correct analyze and scaling of the accounting and internal financial control systems' efficiency, from the presented points of view, allow to the auditor a first evaluation of the control risk level which could influence the quality of the audit opinion.

The understanding and internalizing capacity of the standards concerning the realization of any economic activity by the entity, confers to the auditor important elements which could cause the diminishing of the risk level and, in the same time, make possible a more precise assessment.

A low level of the auditor's capacity to correctly internalize the norms which regulate the economic activities and their implementing methods, by the audited entity, can create conditions for the increase of the level of control risk.

Realizing as many assessments and auxiliary tests as possible by the auditor concerning the audited activity has direct effects in creating a significant fund of legal, real, pertinent and necessary information, with beneficial effects, both in diminishing the control risk's level and, especially, in creating the fundament conditions and delivering an opinion that will correctly reflect the state of the analyzed activity.

Also, a significant number of verifications and control tests determine also a sufficient volume of audit proofs, representing useful information for the analysis and assessments which represent the base of that opinion.

For realizing this objective it is necessary that the verifications' and control tests; area to be as large as possible, in order to insure a sufficient data base for motivating the possible level of control risk.

The final assessment of the control risk level, associated with the audit activity, it is realized through the comparison of the determined level of the basic risk with other audit proofs obtained from applying the procedures and the general audit techniques, especially the ones obtained from applying the assessment procedures, documentary- accounting and actual control.

From analyzing the influence factors of the control risks it can be observed that some of these can be found also among the factors that condition the inherent risk.

Important, in this sense, is the permanent concerning, from the part of the persons responsible with the management of an economic entity, with the improving of its quality through measures that will eliminate errors from the activity, influence factors that determines the reducing of the inherent risk also.

The non-detecting risk represents the risk view as a fund procedure consisting in the auditor not detecting an error that exists in a category of operations and that could be individually material or, when cumulated with errors from other categories. In different words, it represents the probability of the auditor using some non-real information, as an effect of his defective examination and analyzed activities.

Evaluating by the auditor the risk of non-detection can be considered also an auto-evaluation, consisting in enunciating that certain critical points of the analyzed activity are missed in the phase of conclusions' foundation, based on which the opinion will be expressed. As an effect, the level of the non-detection risk depends, especially, of the auto-critical spirit in which the auditor analyzes and orientates its own attitude towards the manner in which he will approach the audit mission.

In risk assessment, the auditor will take into consideration that the inherent risk and the control risk, on one side and the acceptable level of the non-detecting risk, on the other side, exists the following relationship: the higher is the inherent risk level and/ or the control risk, the more necessary is a higher volume of work for reducing the non-detecting risk and for framing in the desired audit risk.

3. Conclusions

The risk level associated with the financial audit as an effect of the three presented documents is an important factor for the quality of the resulted information.

A correct approximation of the audit risk level significantly conditions the fundament process of a real and pertinent opinion that will allow the managerial structure to adopt the most efficient decisions concerning the audited activity.

References

Barbacioru, V. (coord.), *Contabilitate financiara*, 2d ed, Craiova, Ed. Universitaria

Selisteanu, S., *Fiscalitate*, Ed. Universitaria, Craiova, 2004

Selisteanu, S., *Elemente de contabilitate*, Ed. Universitaria, Craiova, 2011