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RISK ASSESSMENT IN FINANCIAL AUDIT

Review Article

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Abstract

Audit risk is the risk of expressing an inappropriate audit opinion with reference to financial statements that are materially misstated. Risks exist but the audit objective is to mitigate the audit risk to an acceptable level. The process of auditing the annual financial statements involves a series of stages until the opinion is expressed and during the audit, the materiality threshold and the audit risk are analyzed together. There is a link between the professional judgment used by the auditor during the course of the mission, the auditor's perception of the financial information needs of the users of the financial statements, and the general significance threshold for the overall financial statements. Particular attention will be paid to managing risks by management within the organization. Each organization has a responsibility in managing risks up to the acceptable level (risk tolerance). The auditor will apply risk assessment procedures and the evaluation of the results is based on the assessment of the probability of their materialization and the impact of the risk.

WHAT ARE THE RISKS IN FINANCIAL AUDITING?

The auditor's overall objectives for an audit of the financial statements are:

- *Obtaining reasonable assurance about the financial statements* as a whole that they are not materially misrepresented, whether generated by fraud or error. This will allow the auditor to express an opinion on the financial statements, the extent to which they are prepared in all material respects under a general Financial Reporting Framework applicable at the time of the audit;

Reasonable certification is a high level of insurance, but not absolute. When the auditor has obtained adequate audit evidence to mitigate the audit risk to an acceptably low level, reasonable insurance is provided. (Stoian & Morariu, 2010)

Due to the inherent limitations of the activity, the auditor cannot provide absolute insurance. Based on audit evidence, the auditor formulates conclusions and bases his opinion.

- *Reporting and Communication* as provided in ISAs, in accordance with the auditor's conclusions.

The financial audit is a complex and rigorous process that requires not only knowledge but also know-how from the financial auditor.

Every mission for the financial auditor or audit firm can be a challenge if we take into account that audit engagements are not the same.

Any audit engagement involves risks, one of the auditor's main objectives, being their identification - in the planning phase.

Audit risk is the risk of expressing an inappropriate audit opinion with reference to financial statements that are that are materially misstated.

Risks exist but the audit objective is to mitigate the audit risk to an acceptable level.

The definition and assessment of risks in the audit are provided in the International Standards on Auditing (CECCAR - ISA Guide, 2012):

- ISA 200-Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards of Auditing;
- ISA 315-Identifying and assessing the risks of material misstatement through understanding the entity and its environment;
- ISA 320-Materiality in planning and performing an audit.

MATERIALITY AND AUDIT RISK

The objective of the audit is to mitigate the audit risk to an acceptable level.

According to the International Auditing Standards - Guide to Using ISAs in Auditing Small and Medium-Sized Entities, audit risk presents two key elements:

- Inherent and control risks;
- The risk of undetectability.

Therefore, the risks exist and are manifested regardless of the way of detection and evaluation of the control system, the most important being the approach to risk in financial auditing.

Risk mitigation at the acceptable level implies:

- Assessing the risks of misrepresentation;
- Limiting the risk of detection. This involves applying procedures that will lead to the assessed risks of significant misstatements (at the financial statement level and at the level of assertions for account balances, transaction classes, disclosures).

The audit risk model used in the International Auditing Standards is:

$$AR = IR \times CR \times UDR\ (DR/PDR)$$, where:

AR – audit risk (acceptable);
IR – inherent risk;
CR – control risk;
UDR – undetectability risk;
DR – detection risk;
PDR – planned detection risk.

IR – the inherent risk is the susceptibility of the account or transaction class balance being misrepresented, which may be materially misstated (either individually or aggregated with other misleading presentations before analyzing the related controls).

The inherent risk is composed of:

- General risk (pure inherent risk and environmental risk). This may result from aspects of the nature of the business and management, the accounting function, the experience of the client's previous financial auditor.
- Specific risk. This may result from knowledge of each field of activity, as well as from issues related to the auditor's previous experience.

CR – control risk is the risk that an incorrect presentation that may occur at the level of an assertion about a class of transactions, the balance of an account, or disclosure that may be materially misstated (individually or on an aggregate basis), is not prevented, or detected, corrected by the entity's control system in a timely manner.

UDR – the risk of undetectability is the risk that the auditor's procedures for mitigating audit risk at the acceptable level cannot detect a misstatement that exists and could be significant (either individually or on an aggregate basis).

DR – detection risk

PDR – planned detection risk is the risk that the audit evidence of a segment will not allow the detection of errors or deviations whose value exceeds the tolerable limit if these deviations exist.

The two types of risks (inherent and control) can be a measure of the auditor's judgment on the

possibility of occurrence of errors and is based on the professional judgement.
Thus, the auditor can perform either individual or combined evaluations of the two types of risk, depending on preferred auditing techniques or methodologies and practical considerations.
Materiality threshold in the context of ISA can be defined as the importance of an omission or misrepresentation (intentionally or not) of financial-accounting information that generates the probability that a reasonable person's reasoning based on that information has changed or influenced accordingly.
Materiality refers to the importance of information in financial statements for users of information in making economic decisions
These can refer to decisions on:

- investments and acquisitions;
- business;
- loans granted to entities.

In the sense of the ISA's Guide to Auditing Small and Medium-Sized Enterprises, the determination of the "materiality threshold for the financial statements as a whole" (abbreviated "materiality threshold") is not based on any audit risk assessment. It is determined only in relation to the users of the financial statements. It is normally the same as that used by the preparer (CECCAR - ISA Guide, 2012).
The auditor's objective is to put into practice the concept of materiality in the planning and proper conduct of the audit. The financial auditor when planning the audit will consider those issues that would lead to the material misstatement of the financial statements.
The auditor's responsibility is to lessen the probability that the aggregate of uncorrected or undetected errors in the financial statements exceeds the materiality threshold for the overall financial statements to an appropriately low level.
Thus, the auditor will have to carry out a number of additional works that will provide him with a margin for possible undetected misrepresentations.
This margin of safety is the purpose of the materiality threshold for performance and will allow the auditor to establish significant amounts that reflect the risk assessment for some areas of the financial statements.
The auditor will determine the materiality threshold for the financial statements as a whole, depending on his perception of the financial information needs of the users of the financial statements. He / she will use professional judgment and set the materiality threshold at the highest misstatement that could not influence the economic decisions of financial statements users.

RISK MANAGEMENT BY MANAGEMENT

Each established entity directs its activities according to its purpose or objectives. Regardless of the type of organization, while achieving the objectives or achieving the expected results an event or a situation may occur which can influence the attainment of the goal. This uncertainty is in fact a risk in achieving the desired results and should be regarded as a combination of probability (risk) and impact (consequence on the objective). (ANEVAR - Risk management, 2016)
The outcome of assessing the combination of probability and impact is defined as risk exposure.
Some risks are the organization's own (as a result of internal factors), others are external, they originate in the external environment of the organization.
Risk management is the process of identifying and assessing risks, establishing responsibilities, taking measures to reduce them, periodically reviewing and monitoring progress (Grigore & Listoschi, 2016).
This involves implementing an internal control system that allows managing risks to a level considered as acceptable (risk tolerance).
Risk management by management involves:
A. The development strategy of the organization - the existence of a strategic plan that aims at objectives, opportunities in reaching the established objectives.
The strategic plan of the organization corresponds to the intentions of the shareholders.
B. Identification of the risks, threats that may influence the failure to achieve the established objectives, their partial realization or changes that may occur in the definition of the objectives.
Risks need to be identified in relation to objectives, by areas of risk (organizational, operational, financial, as a result of changes).
They are related to the objectives, the organization's strategy.
C. Risk assessment
Once identified, the risk assessment proceeds with evaluating the likelihood of materialization and the impact they have on the objectives set.
The type of risk will be taken into account:
• inherent risk (specific risk) - which is related to the achievement of the objective;
• residual risk - the risk remaining after applying inherent risk mitigation measures.
The inherent risks cannot be fully controlled, with residual risk being the consequence of this.
D. Monitoring of risks
After identifying the risks, assessing them, the organization proceeds to control the risk through ways established according to the provisions of the strategic plan.
Monitoring can be done through Reports for the targeted action directions.
The organization is willing to assume at some point certain risks, defined as risk tolerance and the strategy it has to fulfill:

- Accepting risks as a risk response strategy for low-exposure risks;
- Risk outsourcing is a strategy aimed at entrusting risk management to a third party, based on a contract concluded (for example financial ones).

E. Risk reduction

This is how the risks are handled, the implementation of the internal control system in order to keep the risks at a tolerable level.

Aspects may be:

- Credit risk;
- Operational risk caused by human errors, reducing the events that can generate them;
- Currency risk, interest rate risk;
- Liquidity risk, etc.

We made this presentation on "management of risks by management," starting from the premise that based on the provisions of paragraph 489 (1) of OMFP 1802/2014 - Accounting Regulations on the individual annual financial statements and the consolidated annual financial statements, the Board of Directors draws up a report of the administrators which also contains a description of the main risks and uncertainties that it faces. (OMFP 1802/2014)

In the Auditor's Report there is a paragraph referring to "Other Information - Administrator's Report", where reference is made to section 489-492 of OMFP no. 1802/2014.

The Financial Auditor is required to assess whether there are significant inconsistencies between the Administrator's Report and the Financial Statements if the Administrator's Report includes, in all material respects, the information required by OMFP No. 1802/1414, paragraphs 489-492 and whether based on knowledge and understanding gained in the course of the audit of the financial statements regarding the Company and its environment, the information included in the Administrator's Report is materially misstated.

RISK ASSESSMENT IN FINANCIAL AUDIT BY THE FINANCIAL AUDITOR

The audit approach in the sense of the ISA's Guide to Auditing Small and Medium-Sized Enterprises includes three distinct stages (Dincă & Stelea, 2015):

Risk Evaluation

What are the risk factors for business or fraud?

What could cause a significant misstatement in the financial statements?

The answer to the risk

Have there been business or fraud risk factors and have significant misstatements in the financial statements been generated?

Reporting

What is the audit opinion based on the evidence obtained and is appropriate to the financial statements?

According to ISA 315, Customer Knowledge and Risk Assessment aims to understand how the company, its environment and internal controls work, so as to identify and assess the risks of material misstatement of financial statements due to errors or frauds, and for to carry out additional audit procedures.

In order for the auditor to make reasonable conclusions to underpin the audit opinion, he / she must obtain audit evidence. Audit evidence may be obtained either by applying background procedures, control tests or a combination thereof.

The auditor will have to obtain sufficient audit evidence to enable him to issue reasonable conclusions on which to base the audit opinion.

Audit evidence must be adequate and sufficient.

Appropriateness refers to the quality of audit evidence, its relevance and credibility as support for transaction categories, account balances, disclosures and assertions, or in detecting distortions from their level;

The degree of sufficiency refers to the amount of audit evidence.

Depending on the degree of adequacy and sufficiency, the financial auditor expresses his opinion on the position in the assertion regarding the financial statements and the result of the financial statements of the audited financial year.

Ensuring the integrity of the audit opinion, the efficiency and effectiveness of the entire audit process requires the use of professional reasoning on external and internal information, including those obtained through audit evidence, through the various techniques used, analyzed and compared throughout the audit process.

The choice of audit procedures by the financial auditor, the methods, the techniques and the application method, is based on professional judgment.

Depending on the understanding of the nature and purpose of the audited entity, the auditor is free to address items that relate to risks, information request, communication with the previous auditor, application of accounting policies and procedures, detailed procedures using test procedures, etc., based on professional judgment and ISA.

Depending on professional perception and reasoning, the financial auditor can also use for the risk assessment:

i. Analyzes and detail tests used at the assertion level;

The types of analysis can be:

- Comparative analyzes - making comparisons of the levels or relationships declared for the current exercise compared to the previous exercises, without making the corrections imposed by the changes that each element has incurred. Comparative analyzes

require that a subjective accuracy threshold be set at which all fluctuations can be considered important. The precision line can be correlated with the significance threshold. Comparative analyzes can provide some degree of fairness to audit evidence obtained by the auditor.

- Predictive analyzes - assume a comparison of levels through indicators, fluctuations, etc. It is a percentage ratio between two economic and financial amounts for the current year, taking into account the trends arising from the levels of the previous year's indicators. Compared to the comparative analysis, the previous exercise data used to perform the predictive analysis is corrected to take account of any known changes in the factors that may influence the data. For example, a change in the sales prices of the products or service charges services is the operation that produces a higher level of estimates than comparative analysis. Preliminary analyzes allow for a higher degree of certainty because they require a higher accuracy threshold to be established on the relevance of the most important fluctuations;
- Statistical analyzes - tools of scientific knowledge, a complex way of thinking, which allows in-depth knowledge of many sub-domains.

The goal is the study of a set of observations made on some statistical units but showing variables (variables) that are classifiable, ordered or measured. They are similar to the predictive analyzes, but they are characteristic of providing more reliable predictions of the dependent variable and allow objective measurement of confidence and real accuracy of the forecast. The objective of statistical analyzes is to achieve a high level of certainty in audit evidence.

Global Analysis > Assumes an account balance based on information known and verified with the audited organization's accounting data. For example, the auditor can check the number of units by different categories and compare the earnings or results achieved.

The use of detailed tests on assertions related to financial statements aims to obtain assurances regarding the existence, correct assessment, affiliation and presentation of the accounting accounts related to the assertion.

ii. Regularity - compliance with the regulations in force.

The primary responsibility of the auditor is to assess the extent to which the client's policies and procedures are in place to comply with applicable law.

Ensuring that situations of non-compliance with laws and regulations that could have a significant effect on the financial statements are correctly identified and assessed, constitute the audit objectives at assertion level, "Compliance with laws and regulations", The auditor will have to verify issues that may constitute an indication of non-compliance with applicable laws and regulations.

We consider that the combined use of the types of analyzes presented, together with the detailed tests and the application of regularity can help the financial auditor in expressing and supporting his opinion on the audited financial statements.

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