THE IMPACT OF THE RISK IN AUDITING FINANCIAL STATEMENTS

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Abstract: *Any investor who has to use a financial audit report expects from the auditor an endorsement, a guarantee of the business continuity and, why not, the fact that the business entity s/he has invested his/her financial capital in is not subject to any risks. Many users put the sign of equality between economic failure and the audit risk. Economic failure occurs when the business entity is unable to repay its debts to its creditors because of general or specific economic causes: economic crisis, bad management or inadequate accounting or fiscal policies. The audit risk belongs exclusively to the auditor and appears when the financial statements contain significant errors, but the auditor concludes that the financial statements present a true and fair view of the financial position, of the performance and the change of capital. Because the auditor uses some evidence based on tests, there is a certain risk that s/he will not find a significant fraud.*

Key words: *audit, audit risk, control risk, inherent risk, undetectable risk, financial situations*

1. RODUCTION

The dynamics of the financial and economic development has transformed the nature of the financial management and has also forced the investors and the managers to understand risk in a very different way from the way it was perceived before.

In this context, the activity of audit and certification of financial statements has improved, i.e. it adapted to the new requirements of the business entities and the investors. All these have led to an upgrade of the requirements of the risk assessment. Today, each and every transaction is subject to country, management, evasion, and even bankruptcy risks.

The complexity of the economic and financial transactions, the internationalization of business, the disputes between countries and the level of training of those who prepare financial statements often lead to errors and even fraud. That is why, between those who prepare financial statements and their users a new type of professionals, called *financial auditors* appeared. They express their opinion related to the quality of the financial statements. That is why many investors put the sign of equality between the economic failure and the audit risk.

2. WAYS OF APPROACHING THE AUDIT

Any business entity that contracts an audit mission expects that the financial auditor should offer it a guarantee of the continuity of its business and should tell that it is not subject to any kinds of risks. As the auditors collect the information based on tests or samples, to discover a well hidden fraud may be difficult, and there is always a risk not to discover a significant error, although the audit is conducted in accordance with the international auditing standards.

The expression "to obtain reasonable assurance" is intended to inform users that the auditors can not provide absolute assurance just looking at the fair picture of the financial statements.

The auditors make a critical assessment of the financial statements, and the methods and techniques for obtaining audit evidence in achieving the objectives improve the quality of the financial information and minimize the risks to which the business entity is subject to.

As regards the way of approaching an audit, there generally are the following types of approaches [3]:

a. *the analytical procedures approach*;

b. *the financial - accounting balance sheet approach*;

c. *the approach based on management systems;*

d. *the risk-based approach.*

The analytical procedures approach – the audit resources aim to testing the large volumes of the transactions and the financial-accounting balances, without relying, in particular, on the areas specified in the financial situations.

The financial-accounting balance sheet approach consists in applying the analytical procedures to the financial-accounting balance, only a few limited procedures being performed on the income statement/ the profit and loss account. This type of approach is justified by the fact that if the management's statements of all accounts of the financial - accounting balance (financial position) are tested and verified, then, the performance for the audited financial year will not be significantly erroneous.

The approach based on systems – the auditor assesses the effectiveness of the internal controls of a business entity and then directs the analytical procedures to those areas which are deemed not covered by the internal controls or areas where the internal controls have not worked as planned.

The risk-based approach – the auditor materializes and redirects resources to those areas of the statements that may contain errors, as a result of the risks facing the audited business entity.

3. DEVELOPING A RISK-BASED AUDIT

Since there is no approach to the audit process to ensure the performance of achieving a perfect audit, it is accepted that, for a large part of the larger entities, the *risk-based approach* will minimize the possibility that the audit objectives are not met. The International Auditing Standard 315, *"Understanding the business entity and its environment and assessing the risks of significant errors"* [1], requires auditors to adopt a risk-based approach. ISA 315 also requires auditors to perform the risk assessment of the significant false statements at the level of statements and financial statements, evaluations based on a proper understanding of the business entity and the environment, including the internal controls.

In short, this approach requires the auditors to identify the daily key risks facing the business entity and to consider the impact that these risks can produce on the financial statements and then plan their audit procedures accordingly. Therefore, this approach is also known as "*the business risk approach*".

When using the audit approach based on risk and assessing its effects on the financial statements, the risks can be classified as follows:

a) the financial risks, such as the cash flow risk;

b) the compliance risk - the risk of the violation of the laws and regulations;

c) the operational risks - such as the risk of losing the mission and the risk of losing the data.

Within the risk-based approach the most important objective is to reduce the risk audit – the risk that the auditor has an inadequate opinion about the financial statements.

In conclusion, when planning the audit, the auditor should ascertain how the business risk is related to the business entity's risk and then determine how the business risk approach is essential in using the audit model.

3.1.THE RISK OF THE FINANCIAL STATEMENTS

The audit risk is a function of the risks of the financial statements (the risk that the financial statements to be significantly inaccurate) and of the risk linked to detection (the risk that the auditor does not identify such mistakes).

The risk of the financial statements has two components: *the inherent risk* and *the control risk.*

The inherent risk is the susceptibility of the sold of an account or a class of transactions containing incorrect information that may be individually significant or when they are cumulated with inaccurate information from other sold or other transactions, assuming that there aren't adequate internal controls.

The inherent risk is inversely proportional to the risk of planned detection and directly proportional to the quantity of verified information. A high inherent risk to a particular audited area will increase the quantity of the audit evidence. The inherent risk is limited either to the nature of the element of the financial accounting balance that is analyzed, such as a provision that is expected, or to the nature of the business entity or the industry in which it operates.

The control risk is the risk as an error that could occur in a statement, which could be significant either individually or when combined with other errors, or can not be prevented or identified and corrected in time by the internal controls.

The auditors take into account the control of a business entity together with the detailed control activities and the objectives of the control risk assessment systems of a specific area of the financial statements. The auditor has no control over the size of the control risk or the inherent risk; these are risks of the audited business entity.

The undetectable risk is the risk that the auditor's procedures do not identify an existing error in a statement, error that can be significant either individually or when combined with other errors. As the auditors use their professional judgment in determining the applicable levels of the inherent and control risk, the auditor's contribution has an impact on the allowed risk of the detection. The auditors manage the overall level of the audit risk that they are prepared to accept in a given audit mission, not only by determining the nature and the dimensions of the performed procedures and tests, but also by allocating an appropriate level of the audit resources.

The audit risk model

The audit risk is:

- the risk that the auditor expresses an inappropriate audit opinion when the financial statements contain significant errors;
- the risk that an auditor believes that the financial statements present a true and fair view and expresses an opinion without reservation, when in reality such situations are significantly erroneous.

Audit risk = inherent risk x control risk x x undetectable risk

The overall acceptable level of the audit risk must be established to use this model to combine sources of obtaining audit evidence. This model is based on the policy which states that the trust in audit should exceed 95%. Given that *the inherent risk* and *the control risk* are assessed 100%, then the risk of the undetectable risk is 0.05%, which means that *the audit risk* is less than 5%.

In conclusion, if the values of the percentages of the risk may be assessed for both the inherent risk and the control risk, then for an acceptable level of the audit risk, a level of the risk detection can be provided and thus the size of the required analytical procedures.

3.2.THE AUDITOR'S RESPONSE TO THE ASSESSED RISKS

The risk assessment by the auditor is characterized by subjectivism, which could not be sufficiently precise to identify all the risks of the significant distortion.

The International Auditing Standard 330, *"The auditor's procedures in response to the assessed risks"* [1] presents the auditor's responsibility in identifying the global response and in establishing the audit procedures regarding their nature, time and area extent at the level of the financial statements and the statements.

ISA 330 requires:

A) – the auditor to establish general procedures for approaching *the significant distortion risks* and recommend the nature of the responses to the general procedures;

B) – the auditor to determine and implement the audit procedures in response to the significant distortion risks at the statement level, regarding:

a) the operational effectiveness of the internal controls;

b) the detailed audit tests whose nature, time and area of coverage meet the assessed significant distortion risks at the statement level (substantive procedures).

These procedures are done taking into account the following aspects:

- the risk significance;
- the probability of the occurrence of a significant distortion;
- the characteristics of the classes of the transactions, the balances of accounts or the presentation of information;
- the nature of the specific controls used by the business entity;
- the level of the auditor's pending in order to obtain the adequate audit evidence to determine whether the business entity's control systems are effective in preventing or detecting and correcting the significant distortions.

Operational effectiveness of internal controls

The auditor should apply those procedures which enable the best possible understanding of the internal controls. To *assess the control risk* the auditor should cover the following steps:

a) ***– to use the information gained during the procedures to understand the internal control***

To this end, the auditor makes inquiries, checks the way the procedures are observed, and inspects the documents. As the auditor reaches an understanding of the internal controls, s/he will see the fulfillment of the obligations and will inspect the areas. Thus, the auditor will obtain the evidence related to how the controls actually operate, which allows him/her to assess the risks of the internal controls.

b) ***– to identify the possible significant distortions that can occur at the level of statements***

The auditor takes into account and, implicitly, examines the situations where errors or even fraud can occur for the statements related to important transactions, sold accounts and presentations related to these in the financial statements, in order to identify the possible distortions.

c) – ***to identify the necessary controls***

The auditor may identify the necessary controls that could prevent or detect and correct certain distortions of a potential statement.

Each transaction has four basic functions:

1. *transaction initiation;*
2. *delivery or receipt of goods or services;*
3. *transaction recording;*
4. *considerations.*

The auditor should obtain assurance about the operation of the internal controls for each of the four specified functions.

d) – ***to test the controls***

In determining what tests should be performed, the auditor takes into account the type of the audit evidence to be obtained and the cost of the test.

Once the tests to be conducted were selected, the auditor uses to prepare an *audit program* for testing the controls that s/he planned.

e) – ***to assess the evidence and appreciate the control risk***

The final assessment of the control risks for a statement on the financial statements is based on the analysis of the samples obtained from:

✓ the procedures for understand the internal controls,

and

✓ the tests of the controls related to these.

Determining the level of the assessed control risk is an issue related to professional reasoning.

The risk assessment by the auditor provides a basis for the appropriate audit approach for designing and applying other audit procedures.

Thus, the auditor's professional reasoning leads, for example, to the decision of taking into consideration that one can obtain an effective response to the assessed risk of the significant distortion at the level of a statement:

a) only by testing the controls;

b) only by performing the substantive procedures, without testing the controls.

The auditor's option of not using mixed procedures, i.e. testing the controls and the substantive procedures appears in one of the following situations:

- when testing the internal controls would not be relevant to the respective statement;
- when the auditors carried out the procedures of risk assessment but they could not identify effective controls, relevant to the respective statement.

Regardless of the assessed risk of the significant distortion, the auditor should design and perform substantive procedures for each class of the transactions, account balance and presentation of relevant information.

Other audit procedures, their nature, timing and scope

The *nature* of the audit procedures concerns:

- ✓ their purpose (tests of controls) or substantive procedures
- ✓ their type:
  - • inspection;
  - • observation;
  - • interview;
  - • confirmation;
  - • recalculation;
  - • re-effectuation or analytical procedures.

For each class of the transactions, account sold and presentation of information, the auditor should select the most appropriate audit procedures to obtain the audit evidence about the accuracy and completeness of the information produced by the information system of the business entity, when the information is used to implement the audit procedures.

Time - refers to the period in which the audit procedures are applied, or the date on which the audit evidence is obtained. The audit procedures can be applied every term or at the end of the financial year.

The time of implementing the procedures depends primarily on the risk of significant distortion rated by the auditor and the elements unknown at the time of the initial assessment of the risk, which causes the auditor to modify the audit program.

If the auditor obtains audit evidence about the effectiveness of the operational controls during an interim period, *s/he will have to establish the audit procedures applicable for the remaining period*.

When auditing small entities, there aren't many control activities that could be identified by the auditor, and s/he will have to take into consideration whether it is possible to obtain sufficient appropriate audit evidence without controls.

In order to establish the time when the auditor decides to apply the audit procedures, s/he will take into consideration:

- ✓ the control environment;
- ✓ the date on which relevant information is available;
- ✓ the nature of the risk;
- ✓ the period or the date referred to by the audit evidence.

Certain procedures, such as: *examining the adjustments made when closing* or *comparing the financial statements with the accounting records* may be made only after the end of the period.

There may be situations when the inadequate controls or the transactions unfinished by the end of the period could lead to significant distortions, when the auditor is required to implement the procedures in order to meet that specific risk.

The *scope* of the audit procedures refers to the quantity of a specific audit procedure to be applied, such as:

- a sample size;
- the number of observations of a control activity.

The scope shall be based on the auditor's professional reasoning after taking into consideration:

- ▪ the significant threshold,
- ▪ the assessed risk, and
- ▪ the planned level of assurance.

4. CONCLUSIONS

Based on the above presentation and arguments, we can clearly draw the conclusion that the financial audit, as the field of checking the financial statements, has the main role of assessing critically the financial statements in their entirety, of detecting errors and fraud, of supporting with evidence the management's objectives, and the fact that the financial statements offer an accurate picture of the financial position, performance and modification of own capital.

Any competent and independent auditor gives advice and recommendations to the entities' management in order to minimize the risk of inflation or deflation, to estimate the foreign exchange risks, the risk of not cashing in the debentures and the risk of insolvency.

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