THE RISKS IN THE AUDIT ACTIVITY

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ABSTRACT: *Following the bankruptcy of large firms (Enron, Parmalat, WorldCom) due to incompetence and failure of procedures is necessary to improve the audit work, paying special attention to risk management and taking into account the recommendations of the auditors. This paper presents a detailed analysis of risks that may arise in financial audit of how risk assessment and the factors involved in their estimation.*

KEY WORDS: *auditor acceptable audit risk; inherent risk; control risk; detection risk.*

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1. INTRODUCTION

Financial Audit plays a key role in corporate governance mechanism since the quality of financial reporting information is determined by several levers that operate under this mechanism.

Financial Audit plays an important role in more efficient operation of capital markets, the economy in general, by giving credibility to financial reports that are required to users. In recent decades, international companies engaged in combinations have appeared improper or fraudulent financial promoters of some resounding financial scandals (Enron, Parmalat, WorldCom, Baring, Forward Group Bhd).

Confidence in the role of auditors and their professionalism was questioned after the spectacular failures, but failures have occurred after the auditors have expressed their views on financial work in favorable terms without warning on certain aspects of the audited entities.

The main reasons for these failures common were considered disastrous incompetence, poor allocation of roles and responsibilities, abuse of procedures,

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ignorance of risk management, auditors recommendations neglect, ineffective external audit.

These events have contributed to the emergence of a common interest in the need for improved control and risk management audit and audit work. We therefore take more detailed risks that may arise in audit work.

2. RESEARCH METHODOLOGY

The main research method was to review the most important views and approaches in the literature, articles and studies in national and international press reports and regulatory bodies in the accounting profession.

3. PRELIMINARY ISSUES

The term risk is derived from the Italian word RISICARE which means to dare. *Risk* can be defined as the threat of an action or event that will adversely affect the ability of an entity to achieve its objectives and to successfully execute their strategies (Griffiths, 1998, p.17).

Risk is the threat variable, something might happen, threat refers to an event, something must happen for the risk to crystallize, and if the event occurs, will have an impact on the entity's objectives. The risk under this definition produces a negative impact on objectives. Risk is the possibility or chance that something will happen will have an effect on the objectives of the entity (Griffiths, 1998, p.17).

Risk is the uncertainty of a result which took the form of a probability of a positive nature or threat, of actions or events and should be taken in terms of a combination of the possibility of something happening and the impact that would produce the materialization of this possibility (Treasury, 2004, p.9).

Risk management can be a positive process, the risk arises not only what is wrong, but also activities to be sure they are correct (Ghiță, et al., 2009, p.109).

The risk, in practice, may be perceived as a series of challenges that must appear in the activities we carry, especially when they have to make decisions.

The risk management has proposed to manage uncertain events success.

For any entity, it is important that before identifying risks, to have well defined objectives based on actual and potential risks.

Risks can be grouped according to several criteria:

1. by the possibility to produce (potential risks, possible risks)
2. according to the specific of the audited entity (the entity general risks audited, risks related to the nature of operations, information systems risks, risks related audit procedures).

The potential risks are found in all entities, the most likely to occur.

The possible risks are the potential risks that management has taken effective measures designed to limit there is a high probability that errors occur without being detected and corrected.

General risks arising from specific characteristics of the audited entity entity: the operating sector, the structure, organization, which distinguishes it from other entities.

Examples of general risks of the entity the audited are:

a) risks related to the economic situation (if the entity is in financial difficulty is tempted to contract loans with high interest)
b) risks related to general organization regarding the nature and complexity of the structures and rules (if rules are more complex, the risks of error are large), the quality management (quality decision process leads to a reduction in risk), the lack of procedures (separation of duties reduces risk)
c) risks related to the attitude of management (management of risks involves the use of reliable and efficient systems).

Risks related to the nature of operations made. Transactions recorded in the accounts can be:

1. repetitive, as a result from ordinary activities entity (purchases, sales, production, wages, etc.). Risks of registration errors are determined by the quality of the accounting system.
2. complementary to those repetitive, recorded from time to time more or less regular basis (for example, information relating to amortization, adjustments)

The risks related to the informational systems. Collection and processing system of data should be designed to make possible the prevention, detection and elimination of errors.

The risks related to the audit procedures. The financial auditor plans audit engagement based on its risk factors is estimated, according to his experience, choosing methods, which involve various risks. The risks are difficult to quantify, requiring a laborious analysis. Risks of the financial audit of the environmental are assumed by the auditor who expresses an audit opinion on the inappropriate financial statements.

Audit risk, according to International Auditing Standards, is the risk which the financial auditor expresses his inappropriate opinion when financial statements contain false information.

Financial auditors, seeking a better assessment as to avoid the risk of audit professional sanctions, payment of damages allocated substantial time to identify risks.

The higher the risk is, the financial auditor will spend more time checking.

Risk model used in planning the financial audit engagement, crucial in deciding the quantity of samples collected within each accounting cycle (sales - receipts, purchases - paying attraction - capital repayment) takes the form:

$$RAa = Ri \times Rc \times Rn$$

RAA - acceptable audit risk
Ri - inherent risk
Rc - risk control
Rn - Risk Detection

4. THE MAIN TYPES OF RISKS IN THE FINANCIAL AUDIT

Acceptable audit risk is a measure of the extent to which the financial auditor accepts that the financial statements contain errors that could be significant after the audit report was delivered.

If one financial auditor assumes an acceptable audit risk of 100%, shall mean absolute uncertainty.

If one financial auditor assumes an acceptable audit risk of 0% shall mean certainty in the correctness of financial statements.

Acceptable audit risk (AAR) expressed as a percentage is used in determining the reliability of financial auditor (GI):

$$G\hat{I} = 100\% - RAa\%$$

Financial auditors acceptable in audit risk assessment take account of the economic risk of the auditor or audit firm to be injured from a relationship with an audited entity.

Financial auditors reduce acceptable audit risk due to factors related to economic risk (Arens, et al., 2003, pp.302-304):

a) the extent to which external users rely on financial statements
b) entity audited financial problems after completing the audit
c) the integrity of management.

a) The extent to which external users rely on financial statements.

If the entity's financial statements are used with priority by external users in decision making, it is recommended that auditors to estimate to a lower acceptable audit risk.

Items that indicate whether external users of financial statements are based on are:

- *the debt amount and nature of the audited entity*. In the case of entities with a high degree of leverage financial creditors will be based on the audited financial statements more than in the case of entities with lower leverage;
- *the audited entity's size*. A large entity with many outlets requires the establishment of a lower acceptable audit risk;
- *the number of shareholders*. The financial statements of entities with a large number of shareholders are the source of information for the shareholders and for the authorities.

b) The audited entity's financial problems after completing the audit

If the audited entity goes bankrupt after completion of the audit, the financial auditor is at risk of being contested in court by the audited entity because the entity being the audited is not satisfied with the quality of the audit, whether it wishes to recover some of loss suffered, even though the audit is of good quality.

The elements that indicate a probable financial failure of the audited entity are:

- the rapid growth of profit (loss) indicating possible future solvency problems (including undistributed profits);

- evolution of cash (cash insufficiency indicates future debt problems);
- the business lending (borrowing from financial lenders determines a higher risk of the financial difficulties).

c)The integrity of management

Integrity management is an important factor driving the risks inherent to each objective of financial audit, for each account and the accounting cycle.

An inferior quality of management is shown by the frequent changes in internal audit and accounting, treasury and disagreements with previous auditors, the audited entity crimes of the leadership and suggests the possibility of a conflict with the authorities, owners or employees.

Inherent risk is the susceptibility of information that contains significant errors, either individually or combined with other information.

Inherent risk is the likelihood assigned by the auditor because of the existence of material misstatements in financial statements reflecting the vulnerability of financial statements errors.

The purpose of assessment of the inherent risk is to enable the financial auditor to form a preliminary opinion on the audited entity, which will be taken into account in the planning process.

Including the inherent risk in the model of financial audit is an important concept of the audit theory, requiring the financial auditors to identify the segment of the financial situation shall be most likely the occurrence of errors.

Factors that are involved in the assessment of inherent (Arens, et al., 2003, pp. 305- 308):

- *specificity* refers to the entity the audited entity's operating activities and appeals to the integrity of management;
- *misrepresentation of information*. Lack of management may result in falsifying the integrity of the financial situation, the occurrence of errors in the inherent risk, with the impact on the attitudes and actions of the leaders, the affection of the integrity, the commitment on the competence with impact on the risk control;
- *results of previous audits*. Deviations identified in the audit in the previous period are likely to recur because the errors are of systematic nature, the entities react slowly to introduce the necessary changes;
- *recurring audits*. Auditing entity for a longer period determines that some auditors to use a higher inherent risk in the first year to the next, if in the first year were not found significant errors;
- *Special operations* which are more likely to be wrong registered because the entity has no registration experience (producing damage leases);
- *unusual pressures exerted on the audited entity's management* may be driven by competition, or by a large number of bankruptcies in the industry in question;
- if the accounting system shall be well-formed in the entity, it will ensure efficiency in the registration point.

Control risk consists in the fact that a material misstatement of an account balance may not be discovered and corrected by the accounting system and internal control system.

Control risk is the measure of the financial auditor's assessment of the likelihood that material misstatements may not be prevented.

The financial auditor tends to place the assessment at a level closer to the maximum level of 100% or even 100%. The control risk is directly proportional to the quantity of audit evidence.

Following the assessment of control risk can be record two situations:

- the financial auditor finds that the accounting and internal control system are not functioning efficiently and effectively, in which case the control risk is at a high level;
- the financial auditors identify that the internal control and accounting system is efficient, able to prevent, detect and correct erroneous significant information. In this case, control risk is lower.

Control risk assessment is carried out in two phases, preliminary and final stage.

Preliminary assessment of control risk assessment is the process of accounting systems and the detection of significant erroneous information, performed for each account balance or class of significant transaction.

The financial auditor recorded, in the working papers, information on the accounting systems necessary to assess control risk, and may use descriptive methods and graphical methods.

Descriptive procedures are based on manual procedures, instructions and internal control questionnaires.

Graphic procedures use circuit diagrams (flow charts) for the graphical representation of the circuit control documents and procedures.

In the final stage of control risk assessment, there will be used tests for verification, under which it will be assessed the compliance with the preliminary assessment of the control system and whether amendments are needed depending on audit program items found.

Assessment of control risk at a lower level must be substantiated by evidence obtained through tests of control audit.

The more the assessment of control risk is lower, the financial auditor should obtain more evidence to argue that the accounting systems and internal controls are properly designed and operating effectively.

Detection risk is the risk that the financial auditor's substantive procedures will not detect significant erroneous information individually or aggregated with other information.

The factors that are generating detection risk:

- exhaustive checks transaction risk can be generated by using most appropriate audit procedures, failure to apply to proper specific audit procedures and misinterpretation of results.

- for sample checks the uncertainty arises if it is found less than 100% of items. These uncertainties can not be eliminated but they can be controlled by proper sampling procedures

Detection risk shall be inversely proportional to the risk inherent and control risk and directly proportional to the acceptable audit risk.

The audit risk model used in planning the audit shall be:

$$\text{Detection risk planned} = \frac{\text{Acceptable audit risk}}{\text{Inherent risk x The control risk}}$$

If inherent and control risks are high, the financial auditor shall ensure that detection risk is low and with a high degree of confidence.

If the detection risk shall be high, the quantity of samples planned will be reduced.

If the detection risk shall be small, the amount of samples planned shall be great.

5. CONCLUSIONS

- Risk, viewed in terms of achieving the objectives of advantages and disadvantages: if the risk has a negative impact on achieving objectives it remains a threat, and where they will be positive connotations, opportunities can be ignored or exploited.
- Inherent risk and control risk refer to the risk that the financial statements contain errors, the risks are related to the audited entity and not under the control of the financial auditor. Detection risk is the risk which in the financial auditor does not identify errors, and are compared with the other two types of risks, it is under the control of the financial auditor.
- Acceptable audit risk is directly proportional to other types of risks from of the audit’s environment and inversely proportional to the quantity of audit evidence which is planned.
- Inherent risk and control are interrelated , so management entities shall take measures to mitigate the two types of risks by developing and increasing the effectiveness of the accounting
- Detection risk shall be directly related to the fund procedures used by the financial auditor and can not be totally eliminated, regardless of the techniques used.
- Inherent risk and control belong to the audited entity and detection risk shall be associated to the financial auditor, depending on the nature, scope and execution time of the audit procedures.
- Between the auditor's the assessment inherent risk and acceptable level of the detection risk is the following relationship: the higher the level of inherent risk and control risk, the greater shall be the volume of audit work required to reduce detection risk and to achieve the desired overall of the audit.

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