UNDERSTANDING THE AUDIT RISKS AND DETECTING THOSE WHO ARISE FROM CURRENT ECONOMIC CONDITIONS

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Abstract:
A greater demand for monitoring the financial reporting process can arise from a number of characteristics of the firm and its environment or from external forces. In forming an opinion on the financial statements, an auditor faces various audit-related risks and risk components; he needs to understand the audit risk and their interaction with the objective of obtaining sufficient appropriate audit evidence. The purpose of this paper is to clarify the audit risks and to detect those who arise from the current economic conditions. We found out that auditor should perform more effective audit procedures, should also increase the extent of particular procedures and we highlight some audit risks that may affect an entity.

Key words: *Audit risk, Material Misstatement, ISA, Risk Model.*

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Introduction.

At a time many entities are going out of business, the banks give loans difficult and an unqualified opinion could have a strong influence of an entity. In forming an opinion on the financial statements, an auditor faces various audit-related risks and risk components, it is essential for him to understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining audit evidence.

The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor that states: „Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected". Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated [4]. In performing the audit, the auditor is concerned with matters that, either individually or in the aggregate, could be material to the financial statements. The auditor's responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected.

Understanding the audit risk.

According to the IAASB Glossary of Terms, audit risk is defined as follows: „The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk". Audit risk is fundamental to the audit process because auditors cannot check all transactions. It would be impossible to check all of these transactions,

and no one would be prepared to pay for the auditors to do so. Traditionally, auditors have used a risk-based approach in order to minimize the chance of giving an inappropriate audit opinion, now, audits conducted in accordance with ISAs must follow the risk-based approach, which should also help to ensure that audit work is carried out efficiently, using the most effective tests based on the audit risk assessment. Auditors should direct audit work to the key risks (sometimes also described as significant risks), where it is more likely that errors in transactions and balances will lead to a material misstatement in the financial statements. It would be inefficient to address insignificant risks in a high level of detail, and whether a risk is classified as a key risk or not is a matter of judgment for the auditor[2].

Relevant ISAs.

There are many references throughout the ISAs to audit risk, but perhaps the two most important audit risk-related ISAs are as follows:

ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs.

ISA 200 sets out the overall objectives of the auditor, in the standard we find the nature and scope of an audit designed to enable an auditor to meet those objectives.

The auditor should obtain reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. Reasonable assurance it is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. The standard also requires that the auditor shall plan and perform an audit with professional skepticism, recognizing that circumstances might exist that may cause the financial statements to be materially misstated [6].

ISA 315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

ISA 315 deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through an understanding of the entity and its environment, including the entity's internal controls and risk assessment process. The requirements of ISA 315 are [2]:

A. Risk assessment procedures and related activities.

There is a procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered when designing the audit plan. Also the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

The following three risk assessment procedures are:

Making inquiries of management and others within the entity.

Auditors must have discussions with the client's management about its objectives and expectations, and its plans for achieving those goals.

Analytical procedures

Analytical procedures performed as risk assessment procedures should help the auditor in identifying unusual transactions or positions. They may identify aspects of the entity of which the auditor was unaware, and may assist in assessing the risks of

material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Observation and inspection

Observation and inspection may also provide information about the entity and its environment, it could be observation or inspection of the entity's operations, documents, and reports prepared by management, the entity's premises and plant facilities.

Risk assessment procedures should comprise a combination of the above three procedures.

B. Understanding an entity

Understanding of the entity and its environment is important for the auditor in order to help identify the risks of material misstatement, to provide a basis for designing and implementing responses to assessed risk and to ensure that sufficient appropriate audit evidence is collected.

C. Identification and assessment of significant risks and the risks of material misstatement.

In exercising judgment as to which risks are significant risks, the auditor is required to consider the following:

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires specific attention;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty;
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

The Audit Risk Model.

The audit risk model breaks audit risk down into the following three components[1]:

Inherent risk (IR) - which is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk (CR) - the risk that a misstatement could occur in an assertion about a class of transaction, account balance or disclosure, and that the misstatement could be material, either individually or when aggregated with other misstatements, and will not be prevented or detected and corrected, on a timely basis, by the entity's internal control.

Detection risk (DR)- the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

The model, AR = RMM x DR (Risk of material misstatement (RMM) is the product of inherent risk (IR) and control risk (CR); and detection risk (DR) is the product of test of details risk (TD) and substantive analytical procedures risk (AP)) expresses the general relationship of audit risk and the risks associated with the auditor's assessments of risk of material misstatement (inherent and control risks); of the risk that substantive tests of details and substantive analytical procedures would fail to detect a material misstatement that could occur in a relevant assertion, given that such misstatements occur and are not detected by the entity's controls; and of the allowable risk that material error will not be detected by the test of details, given that a material misstatement might occur in a relevant assertion and not be detected by internal control or substantive analytical procedures and other relevant substantive procedures. The model is not intended to be a mathematical formula including all factors that may influence the assessment of audit risk; however, some auditors find such a model to be useful when planning appropriate risk levels for audit procedures to reduce the auditor's desired audit risk to an appropriate low level[1].

Conclusion.

The recent economic condition may cause additional risk factors that did not existed previously, or did not have a material effect on audit clients. Some risks are:

- Volatile real estate and business markets;
- The credit crisis, which can cause significant measurement uncertainty, including accounting estimates and fair value measurements;
- Constraints on the availability of capital and credit;
- Going concern and liquidity issues;
- Marginally achieving explicitly stated strategic objectives;
- Use of off-balance-sheet financing;
- Special-purpose entities, joint ventures, or other complex financing arrangements.

Many of these risks are not new to businesses, considering of the way that a client is affected by external forces is part of obtaining an understanding of the entity and allow to the auditor to plan the audit to address those risks.

There are also some possible audit responses to a significant risk of material misstatement include increasing the extent of audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect the client, auditors should consider:

(*a*) perform more effective audit procedures,

(*b*) perform audit procedures closer to year end, or

(*c*) increase the extent of particular audit procedures.

Another way to examine some new audit risk is management integrity. During an economic crises period is important because there is an increased likelihood of management acting unethically by violating accounting and reporting rules. Auditors should exercise their professional skepticism at a higher level and not to be satisfied with less than persuasive evidence during the audit. In evaluating the financial statements as a whole, auditors look for patterns of management being too conservative

or too liberal. This may indicate management is attempting to manage earnings by either making the current set of financials look worse or better than they actually are.

The economic climate continues to make accounting for transformations and auditing entities more challenging than ever, the auditors should perform the audit with precaution and to develop and understand all the risks that threat the entity.

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