Managing issues in risk assessment in auditing process

Aspecte manageriale în evaluarea riscului în procesul de audit

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Abstract

The paper intends to present some aspects of evaluating various dimensions of risks as they are necessary to be estimated in the auditing process. The definitions for audit are used to emphasize on the nature of the evidence data and the input information for conducting such an audit. Then, a short characterization of the evaluation of risk and a prioritization procedure are described.

Keywords: *auditing process, risk assessment, prioritization procedure*

Rezumat

Lucrarea intenţionează să prezinte unele aspecte legate de evaluarea diferitelor dimensiuni ale riscurilor care trebuie să fie estimate în procesul de audit. Definiţiile de audit sunt utilizate pentru pune accent pe natura datelor din evidenţe şi informaţiile de intrare pentru efectuarea unui astfel de audit. Se face o scurtă caracterizare a evaluarii riscurilor şi este descrisă o procedură de prioritizare.

Cuvinte-cheie: *proces de audit, evaluarea riscului, procedura de prioritizare*

JEL Classification: M42, G32

Introduction

A common language for executive and line management is the concept of risk, in particular, business risk. Their needs, and their expectations for internal audit, are centered on the effective management of risk through its minimization to acceptable levels. Internal audit needs to take a major role in this regard by working with executive and line management to assist in the identification and assessment of business risks. In doing this it will apply its own business risk analysis methodology. This structured, systematic approach helps to weight and prioritize all significant business risks. This can be undertaken independently and the results shared with management. However, it should be complemented by consultation with executive and line management. It is important that internal audit obtain management's perspective on risk.

This will serve to confirm internal audit's own understanding of the business. Consultation can take many forms. One that is gaining momentum is the use of facilitated workshops which draw out management's perspective on both risk and control in an organization. This approach, generally, goes under the title of 'control and risk self-assessment'. It is common for internal audit to facilitate these sessions and/or to sit in as the subject matter expert on risk and control.

Use of control and risk self-assessment techniques brings greater awareness of business risks and 'educates' management in their own responsibilities for effective internal control. Whichever approach is used to identify, analyze and prioritize risks, internal audit should align its planned program of activity with these priorities. This requires a modification to the traditional approach of programming coverage of a defined audit universe of activities on a cyclical basis. Internal audit plans need to be regularly reviewed and updated to reflect current risks and priorities. The plans need to be flexible so that they can be responsive to management needs.

The role of internal audit is changing; the demands on all organizations to do more with less, to 'add-value', and to strengthen internal governance, have led to a significant shift in management expectations of internal audit and in internal audit's role within the organization. The audit evidence must be persuasive which mean sufficiency and competency (relevancy) of evidence. Accordingly, auditing forecasts needs evidence related to future while auditing historical data needs evidence has the same nature (actual or historical). Auditing standards and related interpretations stated procedures to accumulate audit evidence and techniques to be used to attest the information being audited. If internal audit is to remain relevant, it is important that it, also, recognizes and gives appropriate weight to the needs and expectations of line management.

Overview for auditing process

Auditing is the accumulation and evaluation of evidence about quantifiable information to determine and report on the degree of correspondence between the information and established criteria. Information must be quantifiable in a verifiable form (such as financial statements, income tax return). Sometimes information could be subjective (such as the efficiency of manufacturing operations and effectiveness of computer systems). The criteria for evaluating information also vary depending on the information being audited, in the audit of historical financial statements the criteria are usually GAAP - Generally Accepted Accounting Principles (i.e., they are prepared in accordance with GAAP). The criteria may be assumptions of forecasts or projections, or efficiency and effectiveness standards (criteria).

The purpose of an audit is to:

• assess an activity/subject that is the responsibility of another party against identified suitable criteria, and

• express a conclusion (i.e. opinion) that provides the intended user with a level of assurance about the activity/subject being audited.

The key documents to be produced are the: Terms of Reference for the audit engagement and the final Audit Report. The audit report should mirror the structure of the main audit criteria, taking into account the nature of the project, the stage at which the audit is carried out, and the users for whom the report is prepared.

Audit findings are pertinent statements of fact and emerge by a process of comparing "what should be" with "what is" (i.e. comparing facts with criteria). Main findings will vary in nature but should be addressed in the body of the report whereas underlying and more detailed findings can be addressed in the annexes. Wherever possible, for each key finding there should be a corresponding recommendation. The ultimate value of an audit depends on the assurance which the audit provides and the quality and credibility of the recommendations offered. Recommendations should therefore be as realistic, operational and pragmatic as possible. Recommendations should be carefully targeted to the appropriate audiences at all levels. Conclusions (or the opinion of the auditor) are the auditors overall assessment of the effects of the findings on the subject (i.e. project activities and financial data) audited. Audit conclusions put the findings in perspective upon their overall implications.

The American Accounting Association Committee on Basic Auditing Concepts has defined auditing as: "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users". This definition includes several key words and phrases:

(1) *a systematic process*. As a systematic process, auditing is a logical, purposeful, and structured approach to decision making; it is not an unplanned, haphazard process.

(2) *objectively obtaining and evaluating evidence*. Auditing involves the collection of evidence. Evidence represents information that will affect the auditor's decision process. Evidence may take a variety of forms, such as examination of documents, observations by the auditor, and confirmations of balances from third parties. Although the evidence itself may be more or less conclusive in nature, the process of collecting and evaluating evidence must be as objective as possible.

(3) *assertions about economic actions and events*. A basic component of the auditing process is the collection of evidence regarding assertions about economic actions and events. These assertions often relate to the financial statement. For example, when conducting a financial statement audit, the auditor is given financial information and financial statements by the auditee. These financial statements represent the auditee's assertions about economic actions and events and include not only the financial statements themselves but also the accounting information system and the accounting process,

(4) *the degree of correspondence between assertions and established criteria.* While auditing financial statements, the auditor's objective is to determine whether the auditee's assertions correspond to the established criteria, which typically are referred to as generally accepted accounting principles. In numerous circumstances, however, the auditor examines assertions other than those contained in financial statements.

(5) *communicating results to interested users.* The audit serves little purpose if the auditor gathers evidence about economic actions and events and ascertains these have been appropriately reflected in accordance with established criteria but does not communicate the result to interested users. Users include bankers and creditors, shareholders and owners, and governments.

Introducing risk in the auditing process

Matching the sequential steps of decision making with those of auditing process may lead to a conclusion that auditing could be regarded as business decision process. In the auditing concept, the main point is obtaining and evaluating evidence which is a complex task that requires professional judgment of the auditors. In business decision process, the decision maker, usually follows a sequential steps to select the best option (the decision), these steps includes: define the decision problem, define the alternative choices, identify and obtain information relevant to the decision problem, evaluate the alternative in light of available information (cost of alternatives, possible outcomes, likelihood's of outcomes), select the best option (the decision).

Since accumulating audit evidence is closely related to audit procedures and techniques, the researcher must discuss the audit evidence and related concepts.

Auditing as a Business Decision Process

Table 1

Steps in Typical Business Process	Steps in Audit Process
Define the decision problem	The auditor's decision problem is to determine whether or not financial statements are "fairly presented in accordance with GAAP".
Define the alternative choices	The possible conclusions are either yes or no, that is, the financial statements are or are not fairly presented.
Identify and obtain information relevant to the decision problem	The financial statements consist of a number of interconnected statements of fact related to assets and liabilities, revenues and expenses, and equities of various types. The auditor must obtain information that indicates whether or not those individual statements of fact are reliable. The data set available to the auditor is potentially huge and includes such disparate information as the nature of information processing, deals about individual transactions, changes in current market conditions and the relationship between different pieces of data.
Evaluate the alternatives in light of available information: Costs of alternatives Possible outcomes Likelihood of outcomes	Since the alternatives to be evaluated are whether the financial statements are or are not fairly presented, the evaluation of information is done in the context of either supporting fairness or refuting fairness. Auditors can make two types of errors: incorrect acceptance when the information is not reliable or incorrect rejection when the information is reliable. Auditors use the information that is available to weight the likelihood of the two outcomes.

Steps in Typical Business Process	Steps in Audit Process
Select the best option	If the auditor feels that the preponderance of the information supports fairness, the conclusion that the financial statements are reliable will be selected; otherwise, the opposite conclusion will be reached. Occasionally, auditors will prefer to defer judgment until additional information is available.

In auditing literature, audit evidence means any information used by the auditors to determine whether statements or information being audited is stated in accordance with established criteria. Evidence must be persuasive which require the evidence to be competent and sufficient.

Features for evidence

Table 2

Competency of evidence	refers to the degree to which evidence can be considered believable or worthy of trust, that could be satisfied by selecting audit techniques or procedures that contain a higher quality of specific characteristics such as relevance, independence of provider, auditor's direct knowledge, qualifications of individuals providing the information (evidence), degree of objectivity, timeliness and effectiveness of audittee internal control system.
Sufficiency of evidence	refers to the quantity (amount) of information obtained or accumulated. Accordingly, improving sufficiency of evidence is attainable by selecting a large sample size or even the whole population.

The internal audit function

The internal audit function, today, is exploring all facets of business activity, seeking to establish the mix of activity which best fits organizational needs. The internal audit function can be a powerful aid to the continuous improvement of processes within an organization. It can achieve this through its own audit activity, including benchmarking and peer reviews, or as a participant in the continuous improvement activities of the organization. Internal audit's attitude to the continuous improvement of its own processes signals its commitment to ensuring that it remains responsive to any changes in circumstances, within and outside the organization.

Internal audit activity can be related to underlying audit objectives. These have traditionally been expressed in terms of forming an opinion on:

- the extent of compliance with applicable laws, rules, regulations and directions;
- the effectiveness of the design, implementation and operation of internal controls;

- the completeness, accuracy and reliability of financial and operating information and underlying records; and
- the efficiency and effectiveness of business and program, or service, delivery processes.

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The challenge is to develop a strategic approach to meeting the, often competing, needs of each group of stakeholders. This is best achieved by aligning the internal audit strategy with the overall organizational strategy. Internal audit planning should include all significant business functions and processes. It should be directed toward ensuring that these processes and functions effectively contribute to achievement of the organizational objectives as set out in corporate and business plans.

Broadening the consideration of risks broadens the opportunity for internal audit to add value in critical areas. Benchmarks for achieving a client focus are:

• internal audit solicits line management's perspective and concerns on the operation of key business processes;

• internal audit obtains line management view of the level of key business risks; and

• clear linkages are established between internal audit's risk assessment and its audit plan.

Internal auditing department performance should be evaluated based on four perspectives – financial, customer, learning and growth, and internal business process. Internal auditing department missions and goals should be stated as an integrated set of objectives and measures that describe long term drivers of success.

Where following the evaluation of the internal audit function it is signaled a need for change in one organization, it is important this is approached strategically. This can be achieved by adopting a set of principles, a framework for common understanding, against which proposed changes can be tested for consistency. The research suggests that effective internal audit functions operate using the following principles:

- internal audit enjoy the full support of executive and senior management;
- internal audit seek to meet client needs through a focus on agreed business risks;
- the resources applied to internal audit activities achieve a blend of relevant business expertise, audit skills and knowledge; and
- the internal audit unit includes a culture of continuous improvement.

In order to effectively evaluate the appropriateness of the company's risk management program, the auditor should have an understanding of various factors that may affect management's decisions about the nature and amount of coverage, for instance, economic factors like fluctuations in interest rates, employment data, or projected claims experience.

The Institute of Internal Auditors in the Statement on Internal Auditing Standards has identified a series of areas that would be prime targets for discovering risk factors. policies, procedures and practices; cost centers, profit centers, and investment centers; general ledger account balances; information systems (manual and computerized); major contracts and programs; organizational units; functions such as purchasing, finance, accounting and human resources; transaction systems for activities such as purchasing, inventory, disbursing, cost accounting, treasury, payroll and capital assets; financial statements; and laws and regulations.

Risk factors are the specific exposures that could generate potential problems for the organization: the number of transactions; the value of transactions; their impact on financial statements; the quality of internal controls; the quality of management; the impact of an activity on decision making; the complexity of systems; the liquidity of assets; the ethical climate; the pressure on management to meet objectives; the competence of personnel; the financial conditions; the competitive conditions; the impacts of customers and suppliers; the impact of government regulations; the geographical dispersion; the technological conditions and changes; the organizational changes; and the recency of previous audits.

Use of control and risk self-assessment techniques brings greater awareness of business risks and 'educates' management in their own responsibilities for effective internal control. Whichever approach is used to identify, analyze and prioritize risks, internal audit should align its planned program of activity with these priorities. This requires a modification to the traditional approach of programming coverage of a defined audit universe of activities on a cyclical basis. Internal audit plans need to be regularly reviewed and updated to reflect current risks and priorities. The plans need to be flexible so that they can be responsive to management needs.

The timing and nature of internal audit coverage of operations will be determined by the priorities established through the risk analysis. This may require annual, detailed coverage of high risk areas with less frequent and/or less detailed coverage of lower risk areas.

First, in the list of the identified auditable units/areas, one should establish an order, or a priority order, which is achieved by calculating a priority score as follows:

● *Calculating Initial Priority* - calculated by assigning three simple risk factors and one compound risk factor to each auditable unit. The simple risk factors are rated using a 1 to 5 scale (5 indicating the highest risk); the compound risk factor reflects the interdependence between inherent and control risk (it is compound risk factor is calculated using a two dimensional table with each factor rated using a 1 to 5 scale with 5 indicating the highest risk). The risk factors used are as follows:

○ *assurance* - takes into account results from previous audit reviews with areas where problems have been identified receiving a higher risk score.

○ *materiality* - takes account of the value of financial transactions processed by an area but a high materiality factor was also assigned to reflect intangible factors where appropriate.

1 = < $100,000
2 = $100,000 - $500,000

3 = $500,000 - $2,000,000
4 = $2,000,000 - $10,000,000
5 = > $10,000,000.

○ *audit judgment* - this factor allows taking into account anticipated changes to systems, staffing, procedures etc. impacting upon a particular area.

○ *inherent/control risk* - The inherent risk is the intrinsic risk of material errors/problems occurring within an auditable area disregarding the effectiveness of controls in place. The control risk component is an evaluation of the quality and effectiveness of controls in place to offset the intrinsic risks (these factors are independent; i.e. even though an area has a high inherent risk, if controls are well designed and applied, there is less concern from an audit perspective).

Each of the scores for each factor is given a weighting to reflect their relative importance. The sum of each of these factors multiplied by the relevant weighting provides the initial priority score.

Weights assigned to factors
Table 3.a.

Previous audit assurance	20%
Materiality	20%
Inherent / control risk	40%
Judgment	20%

Inherent / Control risk table
Table 3.b.

Control risk	Inherent risk					
		1	2	3	4	5
	2	.4	.8	1.2	1.6	2
	3	.8	1.6	2.4	3.2	4
	4	1.2	2.4	3.6	4.8	6
	5	1.6	3.2	4.8	6.4	8
	1	2	4	6	8	10

● *Calculating the final audit priority for each auditable area* – process done to ensure that audits not performed in any one year become a higher priority in the next. For each year since they were last audited, a "year loading" factor of 15% compounded is automatically applied to each auditable area, except for divisional audits. The effect of this loading is that an auditable area which is not covered within 5 years has its priority rating almost doubled thereby allowing lesser priority tasks to be incorporated into the plan.

Assessing the risk

The intent of risk assessment is to determine the potential damage that problems related to the function of a specific factor can exert. The damage is related to two aspects: probability; and impact. The assessment should be designed to determine the possibility of a problem occurring and how much damage the organization could sustain.

▲ As to *probability*: the auditor should analyze the function to determine:

- the various damaging impacts that can occur;
- why the impacts occur;
- how the impacts occur;
- conditions that trigger the impact;
- circumstances exclusive of the conditions that foster the impact;
- situations that can have a dampening effect on the impact;
- control that can: forecast the impact, or prevent the impact.

To determine the probability of exposure, it must be considered in a control-neutral condition. This is obvious because if there were tight controls, the probability should be minimal. We are considering the intrinsic probability of the exposure in a control free environment. Following is a five-point scale:

❖ *Very probable*: The exposure is tempting, the operation is simple, the visibility is slight, tracking would be difficult, the rewards are great.

❖ *Quite probable*: exposure is tempting and operation is simple; however there is some visibility and there could be an audit trail. Rewards are less certain.

❖ *Probable*: exposure is tempting, however freedom from discovery is less certain. Rewards are questionable.

❖ *Mildly probable*: some temptation is there but discovery could be a possibility. Rewards are slight.

❖ *Improbable*: the adverse aspects remove any temptation to perform. There are no rewards.

The usual method of measurement would be to multiply the three factors. However, this would result in a fictional product because, for instance a "5" in importance does not have the weight of a "5" in impact or in probability.

Considering the above, the analyst should estimate the probability of occurrence of the activity that will impact on the organization. A scale of: one to five, or one to ten, or a simple scale such as: low, medium, or high, can be used.

▲ As to *impact,* the degree of damage: the auditor should analyze the impact itself to determine, the effect of the presence of: controls, extenuating circumstances, or independent conditions, the amount of damage that can result, controls that can prevent the input, conditions that can have an ameliorating effect on the damage, and conditions that can serve to reduce the strength of the impact or the quantity of damage.

The estimate as to the amount of impact can be described in monetary terms or, if the impact is related to performance of a commonly agreed function by beneficiaries, for example, in percentages.

The impact of the exposure is a relative term - it would be necessary to relate the potential damage to relative terms, thus:

❖ Devastating; could cause the government to face bankruptcy or could result in great loss of life and/or property damage.

❖ Could cause financial embarrassment, but could be recoverable; could result in some property damage and only moderate physical impact on people.

❖ Could result in financial conditions that would only require legislative action to compensate; could cause moderate discomfort for people.

❖ Could result in curtailing some programs but would be recoverable in the short term.

❖ Is embarrassing but has little impact on finances or people.

Conclusion

Although the preparation of comprehensive and systematic analyses has its own resource implications, whether qualitative or quantitative in nature, socio-economic analysis has shown that such assessments can improve the quality of risk management decisions. They can assist in ensuring that all factors are taken into account in decision making and that risk management is correctly targeted, in fine-tuning risk reduction measures, in identifying new options, and, through these, in achieving the most cost-effective use of resources. The problem of studying risk becomes relevant as the business risks might include: failure of a project to meet its objectives; client dissatisfaction; unfavorable publicity; threat to physical safety; breach of security; mismanagement; failure of equipment or computer systems; breach of legal or contractual responsibility; fraud; and deficiencies in financial controls and reporting".

The ultimate point in assessing these risk indicators is to signal possible warnings on problems in the future development of the project investments; then, the organization is called to produce risk management indicators which will be reported annually or periodically by the relevant board committee.

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