

Conference Paper

General Scheme of Risk – Oriented Audit Stages

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Abstract

The article examines the problem of applying risk-oriented approach in audit. A risk-oriented approach on the one hand allows to increase efficiency of auditors' activity, the level of compliance with mandatory requirements, and on the other hand, to avoid the excessive inspections' procedures in the formation of a scientifically grounded framework of reasonable sufficiency inherent to each specific audit. At the same time, risk-oriented approach needs to create its own methodological base, develop methodologies and relevant accompanying documents, and, most importantly, train personnel capable of implementing this innovative methodology. For this reason, topic of this paper is extremely relevant.

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1. Introduction

When applying risk-oriented approach, audit is concentrated in areas with a higher potential risk, which makes it easier to conduct audit in low-risk areas. In addition to accounting (financial) statements and internal control system, the system of managing risks of the economic entity also becomes the main object of the audit. When carrying out an inspection, activities of the audited entity in the amount sufficient to identify and evaluate risks of material misstatement of accounting (financial) statements should be examined.

The goal of accounting (financial) statements' audit is to increase the degree of confidence for its intended users. This is achieved by expressing the opinion (by the auditor) on the result of preparation of accounting (financial) statements in accordance with the applicable basis for presentation of statements in all significant aspects. To make such a statement, auditors collect evidence, on which their opinion is based.

Risk-oriented approach involves conducting an audit in three stages:

1. audit planning;

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2. collection of audit evidence;
3. completion of audit

2. Audit Planning

Audit planning involves development of general audit strategy and preparation of a plan.

The audit planning stage includes the following sub-steps:

- understanding the nature of the task;
- determination of materiality;
- determination of scope;
- identification and assessment of risks of material misstatement;
- planning of procedures in response to identified risks of material misstatement.

Understanding the nature of the task considers the following procedures:

- decision-making on acceptance or re-acceptance of relations with the client of the audit task;
- assessment of compliance with ethical requirements, including independence;
- coordination of the scope of the audit task and fixing it in the contract;
- definition of requirements for the verification of working documents;
- decision of an issue of audit group formation.

Having received an understanding of the nature of the task, it is determined, what is important in the context of audit and formation of an opinion on accounting (financial) statements, the level of materiality is also determined.

In order to form an opinion that the accounting (financial) statements do not contain any significant distortions, it should be determined what to consider significant.

In the process of formation of the overall audit strategy, a professional judgment is applied, and the following indicators of materiality are determined:

- materiality for the accounting (financial) statements on a whole;
- materiality applied to certain elements of accounting (financial) statements (if applicable);
- materiality for performing audit procedures.

When determining the materiality for accounting (financial) statements, in general, a certain percentage of the selected benchmark is applied as the reference point.

The following factors influence the choice of the benchmark (Table 1):

TABLE 1: Benchmarks.

Nº	Factors that influence the choice of the benchmark	Examples of factors assessment
1	2	3
1	Articles that are independent elements of accounting (financial) statements	Assets, liabilities, equity, net assets, balance sheet total, revenue, expenses, profit before tax
2	The users of accounting (financial) statements; their basic information needs; the articles on which they are focused the most	For the purpose of assessing financial results, users generally pay attention to profit, revenue or net assets
3	The nature of the organization; the stage of the life cycle; the industry and the economic environment in which it operates	The newly created organization, which has not started its operations, has no revenue, but has expenses, equity, assets and liabilities.
4	Ownership structure and method of financing of the organization	If the organization is financed solely by borrowed funds rather than equity, users can pay more attention to the assets and claim rights rather than to the profits of the organization
5	Relative variability of the selected benchmark	Profit before tax varies unpredictably from year to year, so it is acceptable to choose the average for a number of years

The permissible range of percentages that will be applied to the selected benchmark is the following (Table 2).

The overall strategy of audit is developed on the basis of the results of evaluation procedures; it reflects the scope, timing and overall direction of audit and serves as basis for the development of an audit plan.

The audit plan details the overall strategy and includes a description of the nature, timing and scope of the planned audit procedures.

TABLE 2: Permissible range.

Nº	Possible benchmarks	Range of acceptable percentages
1	2	3
1	Profit before tax	3% - 10%, inclusively
2	Net assets	
3	Total balance	0,5% - 2%, inclusively
4	Revenue	
5	Expenses	

To design risk-oriented audit plan, the auditor should take into account two aspects of the risk:

- individual events/risks and how they may affect the achievement of the organization's goals;
- inherent risk factors that may indicate a higher or lower level of risk and that can be used to prioritize individual audits in a common audit space.

Thus, risk-oriented audit planning consists of five separate stages:

1. identification and classification of accounting and reporting sections that are most likely to be distorted;
2. identification of individual events in the selected sections that are the most likely sources of risk;
3. categorization of events in terms of the possibility (probability) of their occurrence and the degree of influence (taking into account the actions of management to reduce risk) to determine the level of residual risk;
4. drawing up a risk-oriented audit plan by using inherent risk factors and categorizing criteria for each factor to determine audit priority for all audit objects in the audit space;
5. presentation of the results of risk-oriented planning through the preparation and updating of strategic and annual audit work plans.

Table 3 presents the basic procedures that are required for planning a risk-oriented audit.

Procedures for assessing risks are undertaken to form a reasonable vision of the client's activities and the environment in which it is being implemented, necessary to identify and assess the risks of significant distortion at the level of accounting (financial) statements in general, and in certain prerequisites for its preparation. Risk assessment procedures are usually performed in the form of requests, analytical procedures, surveillance and inspections.

3. Collection of Audit Evidence

Collection of audit evidence implies assessment of risks of material distortion of audited financial statements, determining the adequacy and applicability of control measures on risks.

TABLE 3: Procedures required for planning a risk-oriented audit.

Nº	Risk-based audit planning stages	Basic procedures
1	Identification and classification of accounting and reporting sections that are most likely to be distorted.	<ul style="list-style-type: none"> •fixed assets; •material and production stocks; •receivables;
2	Identification of events that can lead to risks and opportunities throughout the audit space.	<ul style="list-style-type: none"> •analysis of the risk registers to understand the events identified by the management; •determining whether the events identified are exhaustive and discussing with management the extent to which the organization is willing to take risks.
3	Classification of events in terms of probability of occurrence and degree of impact (taking into account management actions to reduce risk) to identify the level of residual risk	<ul style="list-style-type: none"> •to review how management classified events as well as actions taken to mitigate key risks; •analysis of the effectiveness of actions to reduce risks in terms of their impact on the residual risk; •identification of the high level of residual risk to be considered in strategic and annual action plans.
4	Development of inherent risk factors and criteria for each factor in order to determine the priority of audit objects throughout the audit space.	<ul style="list-style-type: none"> •preparation of an initial list of risk factors; •definition of criteria for the classification of each risk factor; •determine whether to add a weighting factor to each risk factor; •discuss the approach with management and their views on the relevance of the selected risk factors, what criteria should be used in the classification and whether the application of weighting factors is necessary; •classification of each risk factor to determine high, medium and low priorities for all audit objects in the audit space.
5	Preparation and updating of risk-based audit plans (strategic plan and work plan for the year).	<ul style="list-style-type: none"> •definition of the strategy and cycles of coverage of different categories of audit space based on the number of risk factor points; •preparation of the strategic document that supports the choice made, due to the used methodology and assessment that allowed to take such decisions; •preparation of a work plan for the year in accordance with the strategy, which defines the specific types of audit to be carried out, their names, timing and expected duration.

The collection of audit evidence when applying risk-oriented approach can be represented in three steps (Figure 1).

International Standard on Auditing 330 defines the duties of auditor in the area of development and implementation of measures to eliminate the risks of significant distortion, identified and evaluated during the audit of financial reporting. ISA 330 recognizes auditing measures to counteract identified risks as obtaining sufficient relevant audit evidence on identified risks of significant distortion [1]. Audit evidence

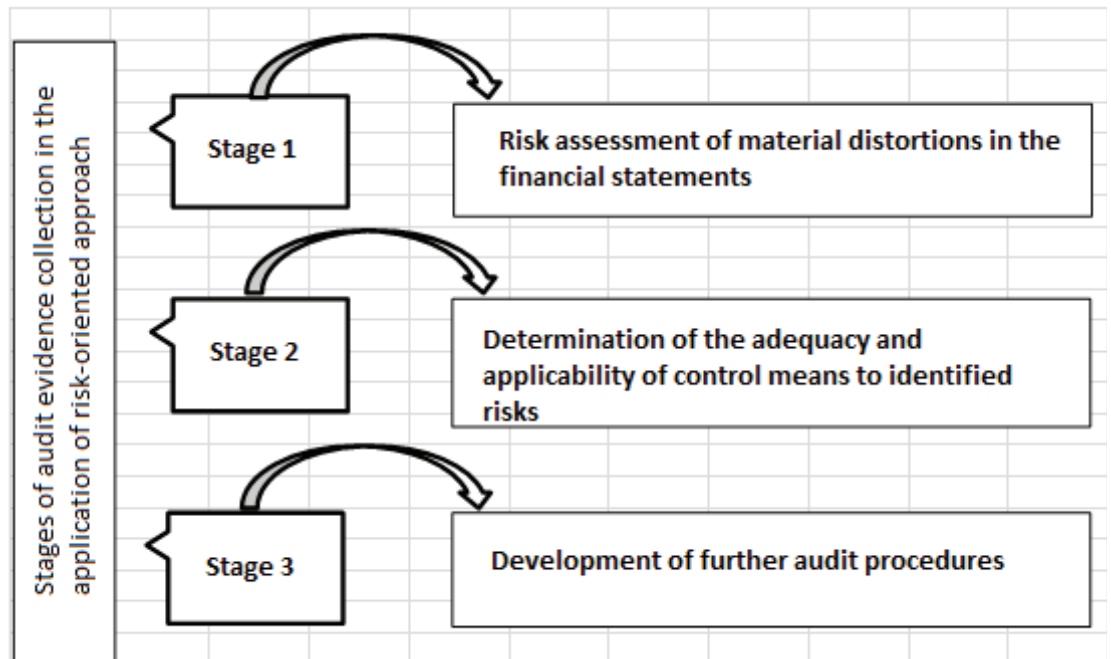


Figure 1: Stages of audit evidence collection when applying risk-oriented approach.

is received by the auditor in the course of performing further audit procedures. The nature, timing and scope of further audit procedures are determined on the basis of an assessment of the risks of significant distortion. For the purposes of ISA 330, further audit procedures are understood as substantive audit procedures and testing of internal control measures. Interpretation of further audit procedures for the purposes of ISA 330 is presented in Table 4.

TABLE 4: Interpretation of further audit procedures for the purposes of ISA 330.

Nº	Further audit procedure	Characteristics of the audit procedure
1	2	3
1	Substantive audit procedures: •detailed tests (classes of transactions, balance of accounts and information to be disclosed); •substantive analytical procedures.	An audit procedure designed to detect material distortion at the statement level
2	Tests of control measures	An audit procedure designed to assess the effectiveness of control measures in preventing, detecting, and eliminating material distortion at the statement level

The auditor should form a proper approach to the development and implementation of further audit procedures. The implied approach is the approach, whereby the auditor needs to determine the following parameters:

- nature of audit procedures;
- timing of audit procedures;

- scope of audit procedures.

Characteristics of parameters of audit procedures for the purposes in accordance with the requirements of the ISA 330 are presented in Table 5.

TABLE 5: Characteristics of parameters of audit procedures for the purposes of the ISA 330.

Nº	Parameter of audit procedures	Characteristics of the parameter
1	2	3
1	Nature of audit procedure: 1.1 Purpose 1.2. Type	1.1. Test of control measures or substantive audit procedures. 1.2. Check. Observation. Request. Confirmation. Recalculation. Re-execution. Analytical procedure
2	Timing of audit procedure	The time of the audit procedure, or the period (date) to which the audit evidence is applicable
3	Scope of audit procedure	Quantitative characteristics of the audit procedure (sample size or number of observations of the use of a certain control tool)

The choice of audit procedures is carried out based on the results of the assessment of the inherent risk, the assessment of the risk of internal control, and the determination of adequacy and applicability of the control measures in relation to the identified risks [2].

On the basis of the above statements, a scheme has been developed for the proper approach to determining the nature of further audit procedures (Figure 2).

The presented scheme of the proper approach to determining the nature of further audit procedures illustrates the relationship between the estimated risk of distortion in accounting records, the determination of the adequacy and applicability of control measures, and the nature of further audit procedures.

Thus, in the event that the internal control measures are adequate to the identified risks and are applied systematically, the auditor can assemble audit evidence based on the test of the control measures. In the cases, when auditor cannot rely on the control measures due to the fact that they have not been developed, they are not established or they do not correspond to the identified risks, it is necessary to apply the substantive audit procedures.

The timing of audit procedures or the period (date) for which audit evidence is applied also refer to the parameters of audit procedures that auditor should choose at the stage of performing further audit procedures. The timing for audit procedures can be presented in the form of three moments of time:

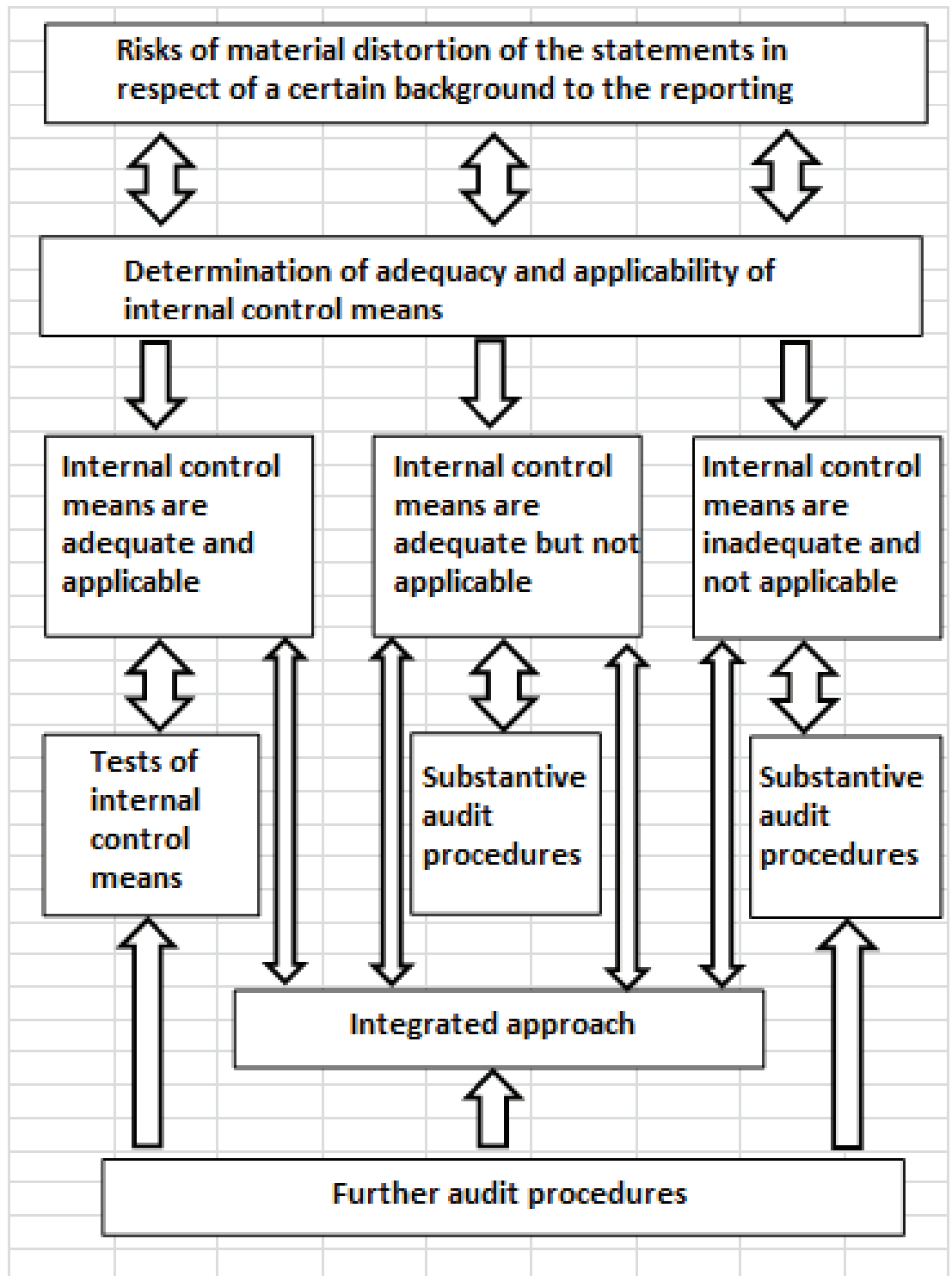


Figure 2: Approaches to determining the nature of further audit procedures.

- intermediate date in relation to the preparation of the annual financial statements;

- end of the period of preparation of the annual financial statements or the time after the preparation of the annual financial statements; sudden checks (procedures are carried out without prior notice to the management of the audited entity).

A number of factors influence the choice of the time or period of implementation of further audit procedures.

At the same time, significant factors include:

- risk level of material distortion;
- the presence of risks associated with fraud;
- ability to identify significant problems at an early stage of the audit;
- the ability to perform procedures only in certain periods of the annual financial statements' preparation;
- results of the evaluation of control environment;
- the moment of obtaining significant information;
- nature of the risk;
- period or date to which the audit evidence relate.

Based on the above statements, a scheme is presented for the proper approach to determining the timing of further audit procedures (Figure 3).

The presented graph of the proper approach to determining the timing of audit procedures allows to illustrate the relationship between the factors that are being investigated by the auditor during the examination and the time when audit procedures are applied. The auditor planned to identify significant problems in reporting at the early stage of the audit, he applied audit procedures at the interim date in relation to the preparation of the annual accounting report. This approach has made it possible to develop measures to remedy significant problems before the start of procedures for preparing annual financial statements jointly with the management of the audited entity.

When revealing a high risk of a significant distortion of financial statements, audit procedures will be effective if they are implemented at the end of the period of preparation of annual financial statements [3].

The presence of risks associated with fraud requires audit procedures to be carried out at the time points chosen by the accidental process, and then the procedures should be implemented without notification of the management of the audited entity.

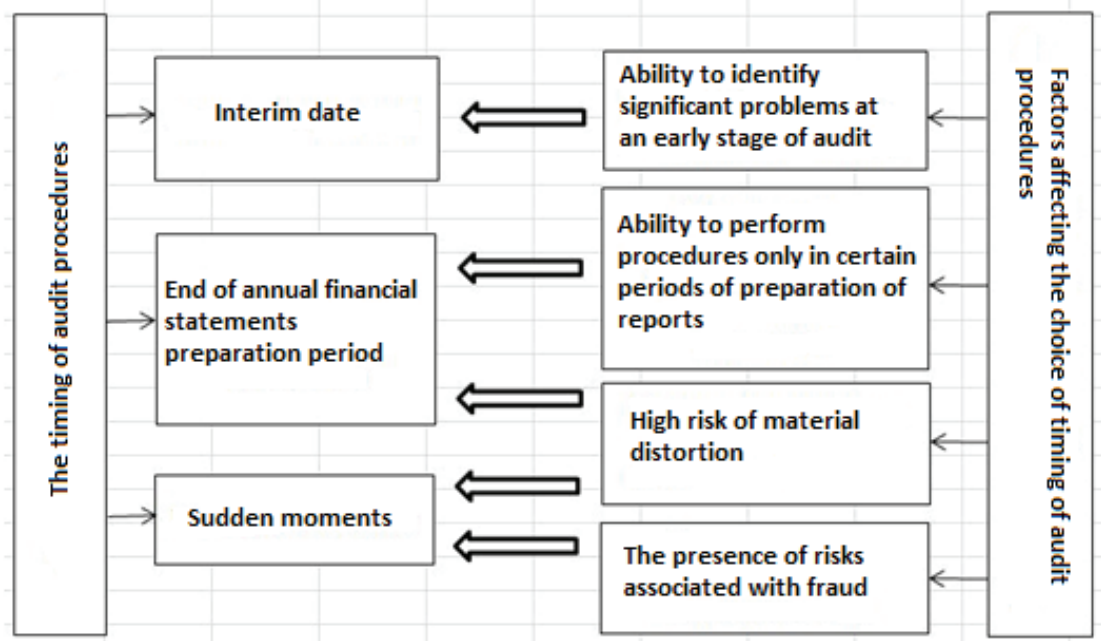


Figure 3: Approaches to determining the timing of audit procedures.

By the moment of the beginning of the process of implementation of the audit procedures, it is necessary to determine the scope. This term (the scope of audit procedures) refers to the quantitative characteristic of audit procedure (e.g., sample size or number of observations over the application of a particular control tool). The volume of control means' testing is influenced by the need to obtain more convincing audit evidence of the effectiveness of these control measures.

When determining the scope of control measures' tests, the auditor also takes into account the following factors:

- regularity of application of the control means during the audited period;
- audit stage, during which the auditor relies on the effectiveness of the tested control tool;
- the expected rate of deviation from the means of control;
- the appropriateness and reliability of the audit evidence to be obtained regarding the effectiveness of the control at the level of the preconditions for reporting;
- the volume of audit evidence obtained on the basis of tests of other control measures related to the precondition for reporting.

The volume of substantive audit procedures is affected by the results of the preliminary evaluation of the level of effectiveness of internal control measures. In the event

of insufficient effectiveness of internal control measures, the volume of substantive audit procedures increases.

Based on the above statements, a scheme has been developed for the proper approach to determining the scope of further audit procedures (Figure 4).

The volume of re-examination procedures is essentially affected by the results of the preliminary evaluation of the level of effectiveness of the internal re-control measures. In the event of insufficient effectiveness of internal control, re increases the volume of re-examination procedures essentially.

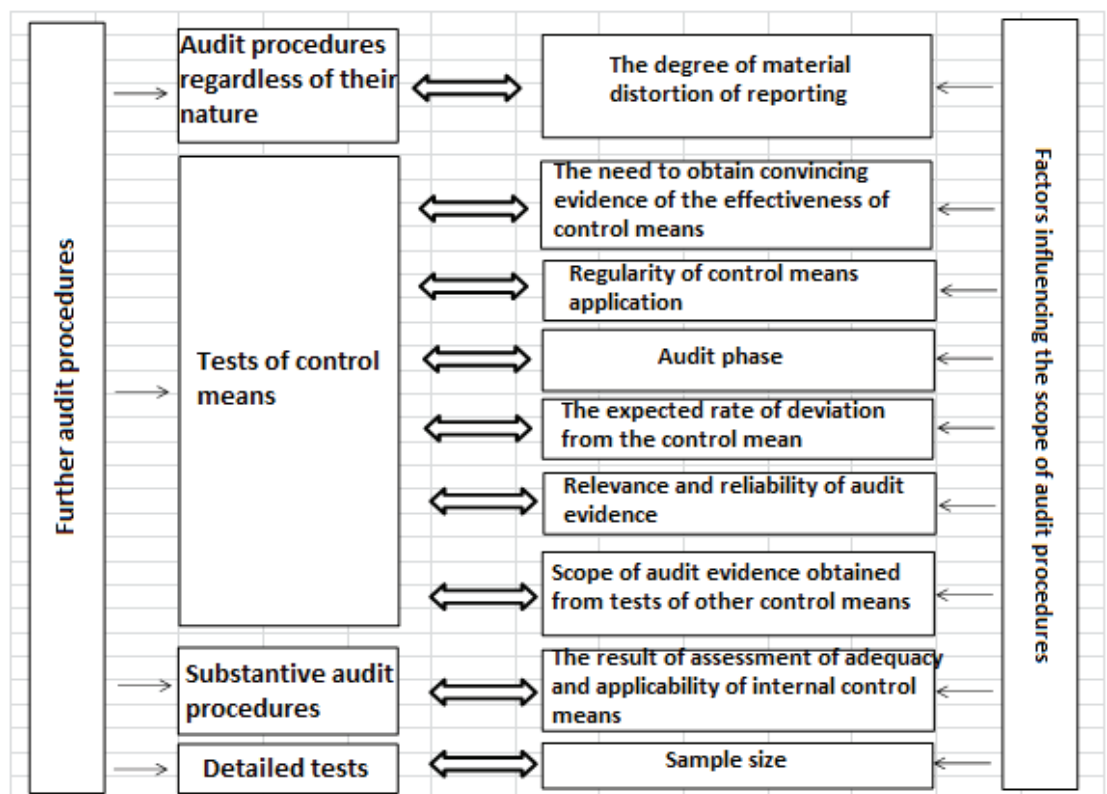


Figure 4: Approaches to determining the scope of audit procedures.

The presented scheme allowed to illustrate the interrelation of the factors that are being investigated by the auditor during the examination, and the scope of application of the audit procedures. When clarifying the practical application of the provisions of ISA 330, the standard emphasizes the importance of a proper assessment of one of the elements of a system of internal control – control environment. The control environment envisions the implementation of management and leadership functions, as well as registration of opinions, awareness and actions of representatives of the owner and managers regarding the internal control system. The control environment is the basis for an effective system of internal control that ensures the maintenance of discipline and order. When assessing the reliability of control environment, the auditor

gets an understanding of how management (under the supervision of owner's representatives) has managed to ensure and maintain honesty and ethical behavior, and has also established appropriate control measures to detect and prevent unethical actions or mistakes. Understanding and evaluating the control environment can significantly change the approach of the auditor in determining the nature, timing and scope of the audit procedures [4].

Thus, the basis for development of audit procedures is the result of risks' assessment and testing of internal control tools. On the basis of the ISA 330 provisions disclosing audit activities aimed at counteracting identified risks, the methodology is proposed for the actions of auditor in development of further audit procedures. The developed approaches to the definition of the nature, timing and scope of further audit procedures can serve as a basis for the creation of methods and working documents for the auditor [5].

4. Completion of Audit

After completion of audit procedures, it is determined whether there has been sufficient evidence that the accounting (financial) statements do not contain significant distortions. For this, the total effect of all distortions detected by us during the audit was reviewed.

All the possible results of audit procedures are reduced to three variants:

- distortions were not identified;
- distortions were identified and they are substantial;
- distortions were identified and they are not substantial.

In the course of the entire audit period, the auditor evaluates the quality of the evidence obtained. At the same time, new significant risk factors or circumstances can be identified that indicate the need to reassess previously identified risks. In this case, it is necessary to determine whether it is necessary to clarify the content of the overall plan and audit program, to review the level (levels) of materiality, to conduct additional risk assessment procedures and further audit procedures. When auditor comes to a conclusion that all the necessary audit procedures have been completed, he now has a reason to express an opinion about the reliability of the financial statements of the client. After the implementation of the internal quality control measures in accordance with the established procedure, an audit report is drawn up, as well as

written information (confidential report) to the management of the audited entity and other reporting documents provided for in the agreement.

It should be noted that the essence of the risk-oriented approach is to understand what, in the first place, prevents an enterprise from achieving the goal, and to find the best way to reduce the negative impact. Therefore, risk-oriented audit allows to define risks in the company's activities, to classify them into groups, to identify key business risks, to reconcile them with the goals and business processes of the enterprise, and to evaluate them.

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