Identification and Assessing Risks of Material Misstatement of the Financial Statements

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Introduction

Assessing the risk of material misstatement in the audit plays an important role, which has a decisive influence on the quality of the audit.

The purpose of the article is to identify factors, which affect risk assessment of material misstatement during the financial statement audit and to define the extended composition of risk of material misstatement. The object of the research is risks of material misstatement and their components. Tasks formulated to achieve the goal: 1) to determine risk factors that may affect specific assertions or be pervasive to the financial statements as a whole and dependencies between the risk of material misstatement components. 2) to identify aspects of improving most common audit risk models. Research methods used in the article include the content analysis of scientific literature, induction and deduction methods.

1. Factors affecting risk of material misstatement

The key premise of a risk-based audit is that auditors should assign more resources to financial statements line items that are more likely to be misstated and less to those that are less likely to be misstated (Kozloski, et al., 2011; Coetzee, et al., 2014). Therefore, an incorrect risk assessment may result in the audit evidence obtained being insufficient to express an appropriate auditor's opinion on client's financial statements.

The risk of material misstatement is caused by entities' activities risk (inherent risk) and control risk. Inherent risk is subject to diversity and complexity because it is affected by many factors (Nguyen, et al., 2020). Number of researchers (Mackevičius, et al., 2012; Ruhnke, et al., 2014; Munteanu, 2015; Selisteanu, et al., 2015; Botez, 2015; Nikolovski, et al., 2016; Florea, et al., 2012; Monroe, et al., 1993) analyzed factors influencing the level of inherent risk and usually distinguishes the following conditions that determine the level of inherent risk: (1) the specifics of the client's business and industry; (2) management characteristics; (3) the size of account balances, the number and nature of transactions; (4) account balances and disclosures (5) susceptibility of property to misappropriation or loss.

However, the inherent risk is caused by far more factors such as complex and strict political and regulatory environment, economic downturn, unstable legal environment, constantly changing technological environment, incorrect business strategy, the lack of business information, failing in the competitiveness (Nguyen, et al., 2020).

The analysis of inherent risk aspects in the literature (Peter, 2013, 100; Mackevičius, et al., 2018, 74; Munteanu, 2015, 100) often emphasizes the separation of inherent risk factors between those that may affect specific assertions and financial statements as a whole. The importance of inherent risk assessment, not only at the level of financial statements but also at the level of assertions, is unquestionable as it allows to plan a specific response to the risks associated with a particular assertion. Therefore, focusing too little on risk assessment at the level of account balances and transactions assertions may reduce audit efficiency and quality.

To avoid the influence of these factors and to reduce the probability of material misstatements, companies are implementing internal controls, effectiveness of which represent the control risk. This risk is affected by the strength of control environment, efficiency of management's risk assessment processes, information and communication, implemented control activities and monitoring procedures in place (Simonaitytė, 2014; Nguyen, et al., 2020).

Finding out the causes of inherent risks and understanding the controls that are created to respond to these risks help auditors determine risk capability of material misstatements. However, the auditor should also consider the interdependence of inherent and control risks in the risk assessment (Ritchie et al., 2007; Dirsmith, et al., 1991; Messier et al., 2000). Without acknowledging interrelations between those risks, the risk of material misstatement may be assessed incorrectly (Munteanu, 2015; Dusenbury, et al., 2000; Messier, 2000).

2. Aspects of improving audit risk models in terms of the risk of material misstatement

Due to the complex risk assessment process, auditors face difficulties in planning the audit, therefore, the scientific literature suggests different risk assessment models that provide guidance for the audit risk assessment process.

The benefits of most common audit risk models are often emphasized in that they provide a better understanding of audit risk and its components and are useful in audit planning, however, the scientific literature agrees on number of aspects for improvement: do not reflect the interdependence between inherent and control risks; the exact method for calculating the level of audit risk components is not provided; inherent and control risk assessments are subjective; do not cover all risks that may arise during the audit; insufficient to assess the risk of fraud; do not show that audit risk needs to be assessed not only at the level of the financial statements but also at the level of the assertions; do not include the need to review the risk assessment during the audit (Arens, et al., 1997; Dusenbury, et al., 2000; Messier, et al. 2000; Bell, et al., 2005; Nelson, et al., 2005; Jankūkainė, et al., 2005; Staniulienė, et al., 2009; Akresh, 2010; Eimanavičiūtė, et al., 2014; Arzhenovskiy, 2019).

Authors also emphasize that the existing models may not be sufficient for the risk assessment of specific risks: existing models provide guidelines for general risk assessment only, and the risk assessment model should clearly reflect the risk assessment process that may have a material effect on the financial statements and requires specific auditor attention due to a more complex assessment process or a higher level of uncertainty. These risks include the risk of fraud, the risk related to accounting estimates, and the risk of going concern (see proposed composition in Figure 1):

- it is difficult to identify fraud by using traditional methods (Kanapickienė, et al., 2004, 27), therefore the assessment of fraud must include specific risk assessment procedures directed at it. In the process of assessing fraud, the auditor should consider the conditions under which fraud occurs, including incentive/pressure, motivation, and opportunity (Marchesi, 2013, 201). The benefits of including these factors in fraud risk assessment have also been substantiated by researchers (Fortvingler, et al., 2016; Mock, et al., 2017);
- revised ISA 540 (2018) specifies that the assessment of inherent and control risks related to accounting estimates must be performed separately. Accounting estimates are one of the most important risks in financial statements, which is widespread and can have a material effect on an entity's financial position and performance (Pinello, et al., 2020, 23). However, auditors face difficulties in auditing accounting estimates (Griffith, 2014, 49) and the scientific literature does not suggest methods to assess the risk of material misstatement associated with accounting estimates (only general inherent risk assessment methods are proposed);
- the going concern risk assessment includes specific procedures aimed at identifying events and conditions that may indicate the entity's difficulty in continuing as a going concern and therefore, traditional methods may be also insufficient for going concern risk assessment.

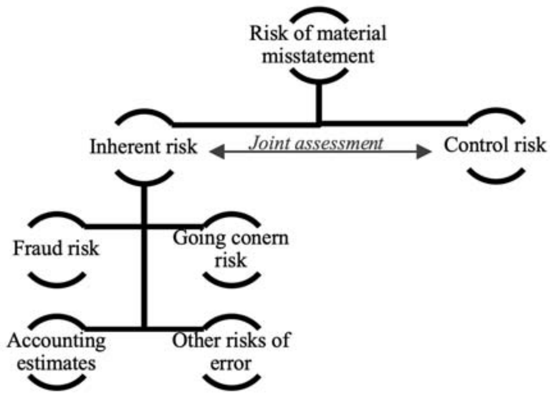

Figure 1. **The composition of the risk of material misstatement**
Source: compiled by authors

Conclusions

1. The level of risk of material misstatement is determined by a number of factors at the level of specific assertions and the financial statements as a whole. It is important that the auditor consider the relationship between inherent and control risks, because ignoring their interrelation may result in an incorrect risk assessment.
2. Various audit risk models were proposed by researchers, however a number of aspects for improvement still exist. Authors emphasize that the risk of material misstatement model should reflect a separate process in assessing risk of fraud, going concern and accounting estimates related risks, the complexity of which is also emphasized in the auditing standards.

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