PLACE OF THE RISK ASSESSMENT PROCEDURE IN THE AUDIT PROCESS IN UKRAINE

CZU: [657.922:330.131.7]:657.6(477)
DOI: https://doi.org/10.53486/isca2023.25

LARYSA HEVLYCH,
Vasyl' Stus Donetsk National University, Ukraine
hevlich.hll@donnu.edu.ua
https://orcid.org/0000-0002-2825-1528

Abstract: The main concept of audit is assessment of audit risk. In our opinion, the entire audit should be considered as a process of continuous and systematic risk assessment. System approach methods were used, comparison, analysis and synthesis, generalization for the formation of algorithms of the auditor's actions regarding the detection of fraud risks and evaluation of the client's internal control system. For practical application, directions for the auditor's understanding of the client's business, development of an audit strategy, detection of events indicating the risk of material misstatements, sources of misstatements, and conditions creating an environment for fraud are proposed.

Keywords: audit, risk assessment, internal control system, material misstatement, fraud.

JEL Classifications: M42, C 13, D 81.

Introduction

The auditor's opinion on the company's reporting is important to the business community as a basis for decision-making. Confidence in the reliability of financial data allows you to make effective decisions, regarding investments and long-term cooperation. But the selectivity of the audit and the dependence on the subjective factor of the auditor's education and experience can affect the reliability of the auditor's opinion. Therefore, clarifying the nature of the audit process is important for reporting users. Understanding the concept of audit risk removes uncertainty about using the audit opinion as a basis for decision-making.

Audit risk assessment has its own characteristics at different stages of the audit, so it requires detailed research. Ukrainian audit has developed for a relatively short time, therefore few studies have been devoted to the study of risks: in 2000-2010, the study of the concept of audit risk began (in articles [8,9]); in 2010-2018, the role of risk in the formation of an auditor's opinion was discussed (articles [2,7]); from 2019 to the present, measures have been proposed to optimize risk assessment (Articles [1,6]). However, risk assessment has always been considered not systematically, but as a separate verification procedure. In our opinion, the assessment of the risk of material misstatement is key in the audit, which requires studying the possibility of presenting the entire audit process through the prism of risk.

The purpose of the study is to consider the process of auditing the company's financial statements as a system of risk assessment based on which the auditor acts. The research used the methods of a systematic approach, comparison, analysis and synthesis, generalization.

Basic Content of the Paper

Usually, risk assessment in the audit process occurs in two cases: when familiarizing with the company's internal control system and determining the overall acceptable audit risk. But, in our opinion, all stages of the audit process can be presented as a risk assessment of the following points:

1) the risk of accepting the task;
2) audit planning risk;
3) the risk of choosing audit procedures;
4) the risk of an auditor's opinion.

The first point is the risk assessment of the auditor's or audit firm's ability to perform the audit task. This cannot be done without understanding the client's business. A summary of the issues that ISA 315 “Identifying and Assessing the Risks of Material Misstatement” recommends being considered are set out in the Table 1.

Table 1. Directions for the Auditor to Gain an Understanding of the Client's Business

Research direction	Question for consideration
Characteristics of the enterprise	• organizational structure, ownership and management structure, business model of the enterprise; • activity markers (key performance indicators, coefficients, trends); • dynamics of financial indicators, forecasts, analysis of deviations by divisions; • accounting policies and changes in them
Enterprise microenvironment	• sectoral, regulatory, other important external factors; • applied conceptual basis of financial reporting; • comparison of markers of the company's activity with competitors
Internal control of the enterprise	• control environment: personnel policy, distribution of powers and responsibilities, declaration of a culture of honesty and ethical behavior; • risk assessment: identification of business risks, assessment of their compliance with the circumstances of the enterprise, assessment of the probability of occurrence and significance of business risks; • monitoring of the internal control system: establishment of sources of information for monitoring, evaluation of the effectiveness of control measures; • enterprise information system: understanding of information processing activities, used resources and policies for determining significant classes of operations, account balances and disclosures, accounting records, financial reporting process, information flows, compliance with reporting principles; • control measures that eliminate the risks of material misstatements at the statement level, aimed at eliminating significant risk, for unusual transactions and adjustments, assessment of the implementation and effectiveness of control measures

Source: MCA 315 Identifying and Assessing the Risks of Material Misstatement

Evaluation of the specified issues allows the auditor to decide whether he can conduct an audit in compliance with regulatory requirements, as well as whether he wishes to undertake such an audit. The audit firm reduces the risk of accepting the assignment to an acceptable level if it can positively answer the following groups of questions [4]:

1. Are there requirements for in-house quality control in the audit firm? Are policies and procedures developed and followed to ensure reasonable assurance of compliance with ISA requirements and acceptability of audit risks?
2. Has the necessary work been done to determine the nature and scope of the audit? Are the proper conceptual basis of financial reporting and accounting standards identified? Are the areas of use of financial statements and audit opinion defined? Is there a deadline for completing the audit?
3. Does the firm have the necessary competence, resources and time? Is there staff with the necessary competence? Is the staff knowledgeable about the company's industry? Does the staff have experience working with regulatory acts? Is there an opportunity to effectively acquire the necessary skills and knowledge? Are experts available? Are there qualified personnel to control the quality of the task? Are the staff able to complete the task within the deadline?
4. Is the audit firm independent? Does the audit team comply with the requirements of ethics and independence? Are measures taken to eliminate or reduce to an acceptable level threat to independence, if identified? Have measures been taken to cancel the task in the event of the impossibility of maintaining independence?
5. Are the associated risks acceptable? Is it possible to communicate with the previous auditor about the reasons for not accepting the assignment? Is it possible to discuss with third parties the reasons for not accepting the assignment? Does the potential client have a culture of corporate values? Is the level of competence of the client's senior management and personnel sufficient? Are there complex or time-consuming issues to consider? Were there any changes during the inspection period? Does society care about the client? Can the client afford the inspection fee? Is the client going to help the audit firm obtain information and perform procedures?
6. Can the client be trusted? Are there limits to the scope or procedures of the review? Are there

reasons to doubt the integrity of the client's owners, management or senior management? Are there signs of a client's misunderstanding of the accounting regulations? Are the related parties in good standing?

Preliminary familiarization with the company's internal control system upon approval of the task continues with the initial assessment of internal control as part of the risk assessment of audit planning. A general verification strategy to reduce such risk to an acceptable level should formalize the key issues presented in the Table 2.

Table 2. Key Issues of Audit Strategy Development

Question	The essence of the question
Task characteristics	• conceptual basis of financial reporting; • the need for special knowledge or experience to consider specific or high-risk areas; • the possibility of using evidence obtained in previous audits; • impact of information technology on audit procedures; • availability of personnel
Reporting purposes	• schedule for submission of enterprise reports; • schedule of meetings with management personnel, top management personnel to discuss the nature, time, scope of audit work, reports, auditor's report; • schedule of meetings and exchange of information between members of the audit team to discuss the risk factors of the enterprise, the nature, time, scope of work, review of the work performed, reports of information by third parties
Essential factors	• the amount of general, special, working materiality; • preliminary risk assessment at the level of financial reporting; • preliminary identification of significant classes of operations, account balances, disclosures, accounting areas with a high risk of material distortion; • the format of reminders to audit team members about the need to use professional skepticism when evaluating audit evidence; • relevant results of previous audits, including identified control deficiencies and measures taken by the client's management to address them; • evidence of management personnel's attitude to internal control
Significant changes and events	• business events affecting the enterprise, including changes in IT and business processes, key management, acquisition and sale of assets; • significant changes in the industry, legal environment; • significant changes in the conceptual basis of financial reporting, for example, accounting standards
Nature, time and volume of required resources	• assignment of work to members of the audit group; • budget of the task taking into account areas with high risks of significant distortion

Source: Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. 2021 Edition

During the review, through the application of auditing procedures, the auditor should determine whether risks of material misstatement exist at the financial statement level and assertion level for classes of transactions, account balances, and disclosures. By such procedures as requesting information from knowledgeable persons, analytical procedures, observation and inspection, the auditor assesses:

• inherent risk as the vulnerability of an assertion about a class of transactions, account balance or disclosure to a misstatement that may be material individually or in combination with other misstatements;

• control risk as the risk that a material misstatement (individually or in combination with other misstatements) that may occur in an assertion regarding a class of transactions, account balance or disclosure of information will not be timely prevented or detected and corrected by an internal control measure enterprises.

In the process of developing the strategy, audit program, during the verification during the audit procedures, the auditor confirms or refutes the initial assessment of the risk of material misstatements, obtained during the analysis of the client's internal control. Particular attention is paid to the assessment of the risk of misstatement due to fraud due to its possible material impact and the difficulty of identification. The main questions to which the auditor seeks answers are as follows:

1. Is the risk due to fraud or error?
2. Have there been any significant economic, accounting, or other changes related to the risk recently?
3. Are there complex business processes associated with risk?
4. Does the risk relate to significant related party transactions?
5. What is the level of subjectivity in assessing risk information?
6. Does the risk involve significant unusual transactions?

Summarized according to the requirements of ISA 315, events indicating risks of material misstatement are presented in the Table 3.

Table 3. Conditions and Events Indicating Risks of Material Misstatement

Event source	Examples of events
Environmental threats	• activity in economically unstable regions; • limiting the availability of capital and credit; • changes in the industry, accounting standards, IT environment; • consideration of the enterprise by regulatory or government authorities
Features of the enterprise	• activity sensitive to unstable markets; • activity that is significantly regulated; • existence of joint ventures; • significant related party transactions
The internal control system of the enterprise	• deficiencies in internal control; • insufficient number of personnel with accounting and reporting skills; • inconsistency between IT strategy and business strategies; • history of errors, significant number of adjustments, unusual operations
Enterprise solution	• assumptions regarding continuity of activity; • liquidity issue; • development of new products, services, activities, expansion into new regions; • major acquisitions, reorganizations, probable sale of business segments; • installation of significant new IT systems, changes in key personnel; • events that contain significant estimation uncertainty; • claims and contingent liabilities

Source: ISA 315 Identifying and Assessing the Risks of Material Misstatement

Thus, the auditor should assess the risks of sources of misstatements, by identifying:

• business goals and strategies: inappropriate, unrealistic, excessively risky goals and strategies, new products, services, business directions, actions in response to rapid growth or decrease in sales that may overload the internal control system, use of complex financing mechanisms, corporate restructuring;

• external factors: the state of the economy, changes in state regulation, a decrease in demand for the company's products, complex regulation of activities, accounting processes, reporting, changes in the industry, the inability to obtain the necessary resources, limited availability of capital;

• the nature of the business entity: weak corporate culture and management, incompetent personnel in key positions, changes in key personnel, complex operational activities, organizational structure, inability to recognize the need for changes, deficiencies in the internal control system, business continuity and liquidity problems;

• performance indicators: lack of a set of indicators that are used by management personnel to evaluate the company's activities and achieve goals, lack of use of the evaluation of indicators to improve operational activity or take corrective actions;

• accounting policies: inconsistent or inappropriate application of accounting policies;

• internal control: inadequate supervision of management personnel over current activities, weak or absent procedures for controlling activities at the enterprise level, weak or absent procedures for controlling operations, poor protection of assets.

International auditing standards assist in identifying the conditions that give rise to the risk of material misstatement due to fraud (Table 4).

Table 4. Conditions that create an environment for fraud

Condition groups	Examples of events
Incentives and pressure	• the financial stability or profitability of the enterprise is threatened by economic, industry, regulatory, operational conditions; • there is excessive pressure on management personnel to fulfill the requirements or expectations of third parties; • personal financial obligations put pressure on management staff or employees who have access to cash and other assets; • there are unfavorable relations between the enterprise and employees who have access to cash or other assets; • the personal financial situation of the management staff may threaten the financial results of the business entity
Attitude and justification	a) justification: • management personnel are interested in using inappropriate reporting adjustment tools; • the behavior of employees indicates dissatisfaction with the enterprise; • low morale among senior management personnel; • management personnel do not implement the values, principles, and ethical standards of the enterprise; b) attitude: • management personnel have a history of violations of regulations, fraud charges, demonstrate changes in lifestyle that may indicate misappropriation of assets, do not take appropriate measures to correct deficiencies in the internal control system; • senior management personnel demonstrate a bad ethical example; • there are disputes between the shareholders of the business entity; • there is a strained relationship between senior management and the auditor
Opportunities	a) assets vulnerable to misappropriation: • large amounts of cash on hand, easily convertible assets; • small-sized goods and material values that have a high value and are in high demand on the market; • property and equipment are small in size and do not have identifiable ownership; b) improper internal control: • on the part of senior management personnel over management processes; • over the expenses of senior management; • over employees who have financial responsibility; • on access to automated accounting; • improper accounting of assets, insufficient authorization of operations and physical protection of assets; • lack of full and timely verification of assets, timely and proper documentation of transactions; c) particularly vulnerable areas: • accounting estimates of management personnel; • areas of recognition of expenses and income; • transactions with related parties

Source: Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. 2021 Edition

The general algorithm of the auditor's actions when identifying fraud risks can be presented:
Step 1 – gather relevant information as a starting point for a fraud judgment.
Step 2 – development, implementation and documentation of intended audit procedures.
Step 3 – the establishing information relationships, based on the logic of both the client's business operations and the algorithms for its processing in the accounting system.
Step 4 – the auditor notifies management at the appropriate level if fraud is identified or there is a reasonable suspicion that fraud may occur, as well as determining whether the auditor is responsible for reporting the incident or suspected fraud to a party outside the entity.

A visual presentation of the conclusions drawn in the form of a map of identified risks with significant sections of financial statements can speed up the process of further verification due to the understanding of the relationships by members of the audit team. In addition to the list of identified risk factors of business and fraud, such a map should include a qualitative assessment (high, medium, low degree of risk) of the probability of occurrence of the identified risk of distortion and the materiality of the risk for financial reporting if it is distorted. The use of SWOT analysis tools allows you to build a diagram of the relationship between the probability of risk occurrence and its impact (magnitude), by highlighting the following areas: low impact low probability, low impact high probability, high impact low probability and high impact high probability. Risks falling into the latter area (high impact high probability) will require management/senior management action to reduce the probability and mitigate the impact. It is these identified risks that should be defined as significant, those that require special attention during the audit.

Audit procedures for detecting fraud can be represented by the following methods:

1) testing the compliance of the General Ledger entries and the adjustments made regarding their inappropriateness or unusual processing;

2) review of accounting estimates for the presence of bias and possible impact on the risk of material misstatement;

3) assessment of unusual operations from the point of view of the possibility of their execution for the purpose of fraud;

4) assessment of identified distortions, in particular, in relation to other aspects of the audit.

The response to audit risks should be the organization of measures that will reduce the risks to an acceptable level, or, in critical cases, the refusal of further audit and provision of services to the client. A summary of examples of possible audit actions in response to the assessed risks of material misstatement due to fraud, proposed by International Auditing Standards, is presented in the Table 5.

Table 5. Auditor's Response to Risks of Material Misstatement Due to Fraud

Risks	Examples of actions (procedures)
Consideration at the statement level	• visiting departments or performing tests without warning; • the requirement to carry out an inventory at the end of the period; • detailed review of end-of-period adjustments, unusual entries; • performance of substantive analytical procedures using detailed data; • a survey of the staff of areas where the risk of material misstatement has been identified; • comparison of the selected balance sheet accounts at the beginning of the period with the accounts of previously verified financial statements; • application of computerized methods; • testing the integrity of records and operations performed using a computer; • search for additional audit data from sources outside the business entity
Consideration at the level of financial statements: a) regarding income recognition	• performance of substantive analytical procedures; • use of detailed data, computer audit methods; • requests for confirmation by customers of certain terms of agreements; • inquiries of sales department staff, full-time lawyers regarding sales; • monitoring of goods being shipped; • testing controls to determine whether they provide assurance that transactions are true and are properly recorded
b) regarding the number of stocks:	• checking inventory information to identify items that require special attention; • inventory monitoring in certain units without warning; • calculation of balances at the end of the reporting period; • involvement of experts; • comparison of the quantity for the current period with previous periods by class, category of reserves, location; • application of computer methods for testing inventory data
c) regarding evaluations of management personnel	• engagement of an expert to develop an independent assessment and compare it with management staff assessments; • providing requests to others to confirm the ability of management personnel to perform assessments
Consideration of misappropriation of assets	• calculation of funds or securities at the end of the year; • direct confirmation by clients of transactions with them; • analysis of stock shortages by location or type of goods; • comparison of the main indicators of stocks with the industry standard; • computer search of payment information to identify duplicates; • analysis of discounts and returns for unusual patterns or trends; • review of the correctness of large or unusual expenses; • review of approvals for loans to management personnel and related parties; • review of advance reports submitted by senior management

Source: Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities.

It is indisputable that the auditor's response to identified risks depends on his assessment of the effectiveness of the entity's internal control system. In an effective control environment, the auditor places greater reliance on audit evidence generated within the entity, so the overall response to material risks of misstatement may include separate audit procedures performed at an interim date rather than at the end of the period. In an ineffective control environment, the auditor is forced to recruit more qualified and experienced personnel to the task group, modify the nature, time, scope of the planned audit procedures, perform a larger number of audit procedures not on an intermediate date, but at the end of the period, plan to obtain more extensive audit evidence from the procedures essentially. Thus, it is possible to present the algorithm for evaluating the client's internal control system step by step:

Step 1. Risk identification

The auditor identifies business risks and fraud risks that, in the absence of certain control procedures, may lead to material misstatement, assesses the likelihood of the prevalence of risks and their impact: pervasive or limited.

Step 2. Evaluation of the control structure.

The auditor identifies the formalization by the client's management staff of specific business processes to reduce the risks of material distortion due to information requests, applies analytical procedures to assess the degree of risk reduction due to the introduction of control procedures, records the identified weaknesses and deficiencies of the internal control system.

Step 3. Assessment of control implementation

Through observation and re-performance of internal control procedures, the auditor is satisfied that the client's control procedures are effective and effective in reducing the risks of material misstatement.

Step 4. Documenting the process and outcome of the risk assessment.

Based on the description prepared by the management staff and the procedures carried out by the auditor, the progress of the assessment of the client's control system, the discussion of the assessment with the staff and the audit team, the results of the audit procedures and the final conclusions are recorded.

When evaluating the control structure, the "one risk to many control procedures" approach is often used, when each risk factor is considered separately, and all control procedures aimed at it are identified. This approach is useful for reflecting the compliance of risk factors common at the level of the economic entity with control procedures. Instead, the "many risks to many control procedures" approach allows you to use a control structure matrix that visualizes the relationships between risks and control procedures, highlights the components of the internal control system, where it is strong or weak, and identifies key control procedures aimed at many risks or assertions that can be tested for operational effectiveness. Then the summary of the overall assessment of control will structure the key identified risks of financial reporting, the sequence of application of accounting policies, the competence of personnel, the existence of the distribution of powers and responsibilities, the application of formalized control measures, the existence of anti-fraud procedures, the reliability of information system data, the monitoring of control measures, etc.

It is the identified risks of material misstatement, assessed in aggregate, that determine the type of audit opinion.

Conclusion

Thus, based on the requirements of international standards and the economic essence of the audit itself, it is proven that the audit is considered as a process of constant and systematic risk assessment. This assessment concerns the risks of accepting the assignment, planning the audit, choosing audit procedures, and choosing an audit opinion. The generalization of international requirements and interpretations of International Auditing Standards made it possible to form algorithms for the auditor's actions in identifying fraud risks and evaluating the client's internal control system. Also proposed for practical application are the areas of consideration for the auditor's understanding of the client's business, the development of an audit strategy by him, the identification of events indicating risks of material misstatement, sources of misstatements, and conditions that create an environment for fraud. Their application in audit activity can increase the level of understanding of the audit report by the client and users and reduce the complexity of the audit while maintaining the required level of audit risk. Systematized actions of the auditor in response to risks are also presented as audit procedures for fraud detection.

Bibliography

1. Celishchev S. V. 2020. Assessment of the risk of control during the continuity audit based on the determination of the effectiveness of the internal audit of the enterprise. *Agroworld* 1: 37-41.
2. Golub L. O. 2014. Assessment of audit risk and testing of means of control of financial activity of the enterprise. *Scientific works of MAUP* 42(3): 207-214.
3. Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities. Available on the internet: <https://cutt.ly/g35tIgD>.
4. Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. 2021 Edition. Available on the internet: <https://cutt.ly/X3PXcnw>.
5. ISA 315 Identifying and Assessing the Risks of Material Misstatement. Available on the internet: <https://cutt.ly/I35tJOF>.
6. Mykhalyk M. V.; Chubai V. M. 2019.Methods of assessing the level of audit risk: features, advantages and disadvantages. *A young scientist* 1(65): 486-492.
7. Sherstyuk O. 2013. Audit risk diagnosis. *Bulletin of KNTEU* 1: 117-127.
8. Vakarov V. M. 2006. The concept of audit risk and its importance in audit activity. *Scientific Bulletin of Uzhhorod University. Series: Economy* 19: 212-219.
9. Yatsyshin N. Z.; Vakarov V. M. 2005. Audit risk research methodology in audit planning. *Scientific Bulletin of Uzhhorod University. Series: Economy* 17: 244-250.