



# International Journal of Sciences: Basic and Applied Research (IJSBAR)

ISSN 2307-4531  
(Print & Online)

<http://gssrr.org/index.php?journal=JournalOfBasicAndApplied>



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## The Concept of Audit Risk

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### Abstract

There is a link between the concept of materiality of auditing and the concept of audit risk. Auditors aim is to concentrate on those areas where there is a high probability of failure or error. The risk of audit is that the auditor may present an opinion that the financial statements are not presented fairly and impartially when they actually are. The risk of audit refers to the information that the financial statements taken as a whole are fairly represented when they are not. Audit risk is the risk faced by auditors that they will fail to disclose material errors in the financial statements. It is expected from them to give reasonable assurance that there are no such errors. In simplest terms, the audit risk is risk connected to the financial statements; it is about that they are not realistic and objective, and that the auditor is unable to detect that. The risk of revision has the following two components: 1) risk that the financial statements contain false allegations; and 2) risk that the auditor will not disclose them.

The auditor changes the nature, timing and extent of the audit actions in accordance to its own assessment of the risk. If it is evaluated that the risk will be high, then reliable evidence should be collected. The primary goal is to minimize the overall risk to an enough low level, and to achieve more effectively the desired confidence.

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The general audit risk is a combination of different risks of the audit. Therefore, the audit risk of the financial statements cannot be considered as a whole.

**Keywords:** audit; risk; financial statements; concept.

## **1. Introduction**

Having in mind that the audit risk is the risk that the auditor may express inadequate audit opinion when the financial statements are materially inaccurate, the concept of audit risk is very complex concept in the overall audit process. 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” [1].

The audit risk in the audit process occurs in three forms [2]:

- Planned risk (i.e. risk that exists when concluding the contract),
- Extracellular post (unknown risk for the auditor until their work is completed),
- Estimated risk (it is known to the auditor during the audit).

The audit risk is considered as a unity of these two components: risk assessment - risk during collecting and evaluating audit evidence; and business risk - economic impact of the audit assessment. The auditor always plans sufficient procedures that will minimize the audit risk and maximizes the detection of errors, fraud and other irregularities in the financial statements. It is especially important for the auditor to identify the areas of high risk in which mistakes are repeated. In determining the level of risk, the auditor should answer the following questions [3]:

- Are there any incentives to manipulate the data (by directors or officers)?
- Is it difficult to perform manipulation of data within that position?
- Is it difficult to detect and prevent such manipulations?
- Are errors regarding these positions are intentional (accidental)?

If errors occur randomly, it is difficult for the auditor to predict the probability of their occurrence. These errors occur in sectors with frequent changes of staff members or in positions where there are employees with inadequate qualifications. Also, these errors appear in implementation of new job positions, as well as during upgrading the existing computer system for data processing.

Since it is difficult to consider the overall risk of the audit of financial statements, it is necessary to have in mind that the risk of incorrect statements that may affect the financial statements can be grouped into the following three groups [4]:

- Inherent risk (the risk of appearance of significant errors in the reports);
- Control risk (the risk that internal control will not detect or prevent such errors); and

- The risk of non-detection or detection (risk that the auditor will not detect any significant error reports).

Inherent risk is the probability of failure in the absence of adequate control, control risk is the probability of errors versus the presence of internal control and the risk of non-disclosure or detection exists independently of the control by the auditor. The auditor can assess the inherent and control risks, but cannot affect them. In any case, the auditor can control the risk of detection, changing the purpose, time of execution and the details of the revision tests [5].

Besides these kinds of audit risk, the auditor is at risk of losing and disruption of his professional practice due to litigation, adverse publicity or other events related to the financial statements that the auditor had reviewed and the audit reports that are complained.

The second component of the audit risk is the business risk of the auditor. Business risk is present even though the auditor performed an audit and after the review of the financial statements gave the appropriate report. These categories of audit risks are of extraordinary importance during the process of audit.

## **2. Principles of Internal and External Audit and Risks**

Having in mind the subjects that are authorized to perform audit there is an internal and external audit. According to the Committee of the American Association of Accountants (American Accounting Association - AAA) an audit is defined as "a systematic process of objectively collecting and evaluating evidence related to reports on economic events and results in order to verify the level of compliance between the existing operational reports and predetermined criteria and to distribute the results to interested parties".

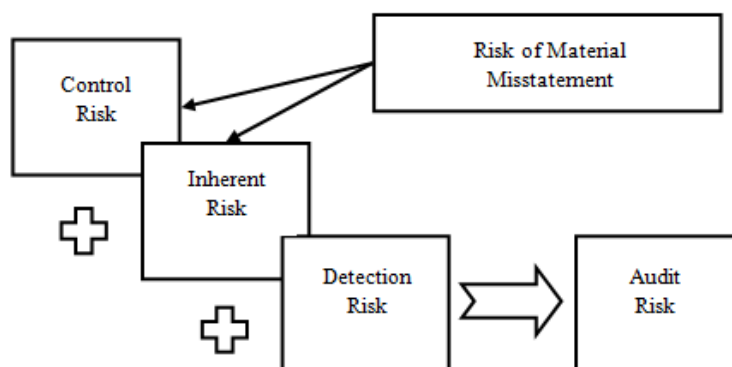
While we are talking about internal audit, we mean about the activity which is organized by the economic entity management, and which has a purpose in assessing the operational results in an entity as a whole or in its separate segments. It is part of the information subsystem of enterprise which will provide the management with information for making appropriate business decisions. External audit is performed by external (state) auditors, they have a duty to express an opinion on the financial statements, and they are independent from the management of the audited entity, acting in the interests of the wider public and contribute to increased economy, efficiency and effectiveness and to prevent the corruption and other types of fraud and financial abuse.

The final purpose of the audit is to provide evidence of a reliability of the information obtained from those which are entrusted by the management, to all interested parties. The management of the economic entity is obliged to create, implement and store accounting records and to take care of the preparation of financial statements in accordance with generally accepted standards and financial reporting framework.

The performance of the audit (internal and external) means to respect certain principles of the audit. A professional accountant – internal auditor and the external auditor must respect the following basic audit principles in order to minimize the audit risk:

- *Objectivity* - to not allow conflict of interest, any bias in decisions making; or any influences from other entities that are contrary to professional or business discernments;
- *Integrity* - the auditor must be sincere and honest in all professional and business relationships;
- *Confidentiality* - the auditor must respect the confidentiality of information on which he/she has an access as a result of his/her professional and business engagement. This means that the information available to him/her is not allowed to be disclosed to other parties without a corresponding and specific authority, except if he/she is authorized by law or required to disclose such information. Also, the auditor must not use the information acquired in the process of auditing for any kind of personal benefit, and if it is proven such activity, it will be legally sanctioned;
- *Professional behavior* - the auditor is obliged to comply with relevant laws and regulations and avoid any action that can discredit the profession;
- *Conflict of interests* - the auditor must not perform audit activity if there is any a form of conflict of interest with the subject being reviewed.

Efficiency and effectiveness of the business entities financial statements audit largely depends on the understanding and implementation of the three fundamental auditing concepts: the concept of materiality - relevance, the concept of audit risk and the concept of audit evidence. Although these three concepts are indissolubly related and realize mutual interactions, at the core of the elaboration of this paper is exactly the concept of audit risk. The audit process is constantly followed by a risk - the risk that the auditor can make mistakes in expressing his/her opinion on the accuracy and validity of the data presented in the financial statements. Audit risk as a whole consists in the existence of a potential possibility for the auditor to present a positive opinion on the audited financial statements (by mistake or on purpose), even in circumstances where they de facto contain material shortcomings in the results in the way of presentation. Professional auditing standards the audit risk identify with the aforementioned risk types: Inherent risk, Control risk and the possibility for the auditor to not reveal all material shortcomings in the presentation (Detection risk). See Figure 1 for the interactions of the components of the audit risk.



**Figure 1:** Three components of Audit Risk

There is a one risk more for the auditor, so called business risk, which indicates the possibility the auditor in

his/her professional activities to suffer loss or erosion of his/her business reputation as a result of any litigation or negative publicity in public, immediately initiated by the revision.

Considering the importance of the concept of audit risk as a whole, and the purpose of the inherent, control and detection risk in order to show the main components of the audit and audit risk, the following chart may be used:

### **3. Inherent Risk**

The inherent risk (present, systematic or integrated risk) cannot be controlled and in the planning of the audit process it is necessary to analyze the conditions of its occurrence.

Inherent risk arises as a consequence of the nature of operations, the types of transactions or the nature of the balance of accounts. This risk is sensitive to the account balance and the class of the transactions, it is sensitive to incorrect material claims also, and can arise despite the existence of some kind of internal control structure.

Inherent risk is a doubt or danger arising from an individual or group error reports, assuming that there was adequate internal accounting control. The auditor assesses the level of inherent risk based on his/her professional judgment, taking into account factors that affect the appearance of inherent risk and whose occurrence cannot be controlled. Those factors can be:

- Conditions in the environment of the enterprise in the sense of the relationship: enterprise-customer, and which affect the financial statements;
- Specific accounts and transactions which are subject of examination.

General economic conditions significantly affect the management level of inherent risk, and thus the misstatement of the financial statements.

Factors of environment are [6]:

- The economic and competitive conditions in the sector in which the company (or clients) belongs - (changes in technology and accounting practices, etc.);
- The general economic conditions (changes in state regulations, inflation, recession, etc.);
- Nature of the business entity (characteristics of the production facilities, technical obsolescence of products or services, etc.);
- Unusual pressures on company's management;
- Experience, honesty and knowledge of the managers that prepare financial statements.

Some transactions and accounts are more susceptible to errors and irregularities than others. The most important factors that determine the level of inherent risk are [7]:

- Susceptibility and account errors;
- Complexity of individual transactions;

- The susceptibility of property loss and fraud;
- Addition of a not usual and complex transactions at the end of the year;
- Transactions which are subject to strange way of processing and so on.

Unusual relationships between accounts give to the auditor "early warning" of the existence of inherent risk.

#### **4. Control Risk**

Control risk indicates that the structure of internal control in the company will timely prevent or detect incorrect material claims. Control risk refers to the risk that the internal control does not act preventively in the sense of correction of the material misstatements.

The auditor have to document the elements of the controlling structure based on the following procedures: a review of previous audit reports, by interviewing the staff of the sector of supervision regarding the execution of their duties and updating of working documents from the previous revision. Control risk is expressed in coefficients (ranging from 0 to 1) or in relative indicators - percentage digits (ranging from 0 to 100%), while the beginning and the end of the range are extreme cases [3].

The first case (the beginning of the range) suggests that control structures are so reliable that there is no possibility of error. The other extreme (the end of the range) indicates that internal control structures are unreliable and that there is a high probability (certainty) that errors will occur. After the inspection of the internal controlling system, auditors usually decide to control the conditions in the environment (which is a part of the inherent risk), to control the accounting system and the controlling procedures. If the accounting system and the controlling procedures are assessed as efficient and effective, then the level of control risk (as a stage in the process of audit risk assessing) can be considered as low. The exact level of the estimated risk depends on their subjective professional attitude. Finally, we can conclude that before the adoption of the conclusions of the audit, it is necessary to examine and verify the previous step of estimated risk control.

#### **4. Risk of Detection**

Despite the inherent risks and control risks, the audit practice encompasses also risk of detection which result from an inadequate or insufficient audit procedures, and may include testing of some transactions which is based on random (or for some reason) selected samples of transactions. This type of audit risk refers to the possibility of the existence of errors that auditors cannot disclose by the independent analytical procedures and have to tests the details additionally. The risk of detection or detection of risk has an impact on the assessment of the inadequacy of the system of internal control, and the assessment of the inadequacy of supervision.

Inherent and control risks are often evaluated together, because between them there is a high degree of mutual dependence and positive correlation. In contrast, the risk of detection has an inverse correlation. That means in cases of high inherent and control risk, the auditor will accept lower risk of detection. In other words, if the internal control system is sufficiently reliable, the auditor has no problem to collect appropriate evidence, and it reduces the risk of detection (i.e. detecting errors), which reduces the overall risk of revision at an acceptable

level. In order to minimize the overall risk of the audit, the auditor formulates a strategy that should provide sufficient competent evidence. If the total audit risk is higher than usual, or if the auditor assessed it as high, the auditor will react through the following actions: carefully selection of experienced members of the audit team; will be collected more evidence than needed for regular audit, carefully analyzing the evidence collected by a number of reliable sources, and will be prepared a more extensive and detailed audit report [8].

The risk of detection is the risk or the possibility that audit procedures will not detect material errors in the accounts and transactions. The risk of detection occurs as a result of: improper choice of audit procedure, misapplication of adequate audit procedures and misinterpretation of the results of the audit. If the auditor considers that the risk of detection cannot be reduced to an acceptable level, he will express qualified opinion (eventually cancel further engagement) or will refrain from giving an opinion in the audit report.

Auditors are trying to define the planned level of detection, which is a function of the planned level of audit risk, the level of materiality and risk of errors, because the risk of detection determines the nature, timing and extent of independent activities. So, the larger the amount of evidence the lower the risk of failure to detect errors that are present and this reduces the level of risk of detection.

Reviewing together the desired level of audit risk and materiality level set by the auditor, as well as assessment of the occurrence of errors in the financial statements that should be checked, determines the level of risk of detection which the auditor plans to accept, and thus the scope of independent actions that have to be implemented. The lower the planned level of risk of detection, the greater the need for more extensive and more complex independent procedures. Assuming that the level of audit risk is lower than the desired level of security, and if the higher limits of materiality are lower than expected, and in such circumstances the risk of misstatement of the financial statements is unconfirmed high, then the risk of detection will be low and independent audit procedures more extensive. Previous statements about the nature and characteristics of certain types of risks suggest the need for risk quantification which is one of the main tasks of the independent auditors.

## **5. Measurement and Summarizing of the Audit Risk**

It is difficult to determine the existence of the risk of audit, and even harder to measure its height, because it is a subjective category. In practice the level of audit risk is determined by the application of the theory of probability and by using mathematical modeling. It is evaluated as normal or low (30%), middle (60%) and high (9%) [3].

The highest level of risk have positions in which it is easy to perform misappropriation, fraud and other criminal offenses that are difficult to detect (e.g. sale in cash, the cash balance at bank, corrections of the value of doubtful and disputed receivables, the calculated depreciation, etc.).

The overall risk of audit is evaluated by the auditor based on impressions from inherent and control risk. Despite this quantification, however in contemporary literature on audit a universal and generally accepted mathematical model for measuring of the inherent and control risks in combination with the risk of an audit is developed. This procedure takes into account different types of risks, and the auditor assumes that the probability of material

misstatement is 100%. Starting from this assumption inherent risk is used to determine the actual probability of material errors, while it is assumed that no adequate internal control or evidence of implementation of internal control exists.

The probability calculated is adjusted to take into account the possibility that mistakes will discover defects of the control system in the enterprise (e.g.  $80\% \times 50\% = 40\%$ ). It is desirable to reduce thus calculated probability, for example to 36% ( $40\% \times 90\%$ ). Thus calculated indicator shows the percentage of probability of detecting errors by analytical procedures applied by the auditor. The ultimate expectation is likely to reach 5%. Such low probability shows that materially significant errors in financial reports shall be disclosed by independent testing of transactions or account balances.

An additional, the desired level of risk varies from the assessment of the audit risk by the occurrence of inaccurate material receivables. The higher the level of general risk that material errors or irregularities will occur, the auditor should take the majority of the investigations to achieve a low level of audit risk, and vice versa. In high-risk situations where high level of security is needed, the auditor may choose to perform a combination of detailed tests and analytical procedures related to the same accounts and receivables. Different combinations of audit activities and risk assessments, analytical procedures and independent data tests can limit the audit risk at a low level, but some combinations are more effective and more economical or cheaper than others.

At the consideration of the overall audit risk we need to combine individual audit risks implemented on the various balance sheet positions and assertions of the enterprise management in connection with them. Given that each of these methods for audit risk assessment has certain shortcomings, it can be concluded that there is no unified, harmonized and simple mathematical approach of combining these risks and that within the audit profession there is no agreement about the question what is the appropriate low risk [9].

The way to combine the results of the audit of certain balance sheet items depends on how the auditor classifies assets and risks and combinations that are applied during that process. Previously exposed analysis of audit risk intended to provide elements of risk management through a combination of complex procedures that reduce the risk of losses due to errors that may affect the valuation and presentation of the balance sheet items. Possibilities for uncontrolled and undesirable, accidental or intentional errors are minimized by complex activities for identification, assessing and controlling of the audit risk.

If the management of the economic entity refuses to correct or to align financial statements, and accordingly the increased volume of controls does not offer real grounds for reducing the uncorrected wrong amounts stated in the accounting data and reports, the auditor should consider the option of changing the opinion stated in the audit report.

## **6. Conclusion**

Internal audit is performed by internal auditors who are employed in the company. The scope of internal audit activities relates to examining of the reality and objectivity of financial statements, audit of the company's



business, working organization of certain functions, decision-making and the functioning of the information system of the company. The composition of internal control consists of:

- Accounting controls;
- Administrative or managerial control; and
- Internal Control.

Internal Audit function *inter alia* consists in that the auditor can verify the quality of financial statements that are presented to external members who are entitled to vote as part of their responsibility. The successful execution of this function provides adequate certainty in the quality of published financial statements and provides a solid basis for decision making for users for which the reports are intended, as well as those who are legally entitled to use the available data. In fact, thus enables the auditing function of the financial statements to offer benefits to the users in a sense of usability of the data from the financial statements and protection from unacceptable behavior and confidence in the reliability of financial reporting as a basis for their decisions.

The audit is considered as a systematic process which involves objectively collecting and evaluating evidence. Evidence is information that have great influence on the decision making process of the auditor, regardless of the form in which they appear and taking into account the confidentiality of their sources.

As the most important definition of audit is that one considered by IFAC, as follows: The audit is an independent examination of the financial statements, or to those financial information relating to the subject, profit-oriented or not, regardless of its size or legal form, when such examination is done with intention to express an opinion on them.

From the above it can be concluded that the audit report shows the economic activities of the audited entity, the use of resources, the condition of assets and liabilities and financial results of the realized operations.

As a systematic process, the audit is logically structured, and it clearly defines the objectives of making business decisions. In no case the audit cannot be qualified as unplanned process, because it is a systematic process of objectively collecting and evaluating evidence. Likewise, the evidence is information that has a major impact on auditor in the formation of the financial statements.

During the implementation of the audit procedures of the financial statements, the auditor's primary goal is to determine whether the statements of the subjects of audit are correlated with the established criteria usually associated with certain rules, plan or other measures of performance determined by management, accounting standards and other authoritative bodies.

At the core of the external audit is the examination of the financial reports by external entities - authorized independent auditors. This validation is of interest both for the company's shareholders and for society at large. This is confirmed by the fact that based on the information contained in the financial statements, decisions with long-term economic consequences are made.

The role of the audit, its powers, duties and responsibilities that are placed before it, including access to published audit reports, from the beginning of the development of modern audit to the present day are largely changed.

Many researchers, professional associations and organizations; and users of the audit, primarily managers are interested about the expectation an audit to respond to the demands which are placed before them. Also, managers and their partners, and internal auditors are littered with speed entry into a new phase of business development, which should respond to the process of global economic and social change and the rapid development of technology, especially in the information technology, and accordingly the current trends in the organization and management of their organization. The changes that move in the direction of increasing market flexibility, decentralization, information and communication, democratic style of management, teamwork without hierarchy, innovation and knowledge, changes in consumer preferences, etc., before the internal audit and the external audit also imposes a need for cooperation with specialists.

The new definition of internal auditing of the 21st century can be defined as: An internal audit is an independent and objective activity that is guided by the philosophy of specified values in order to improve the organization.

It assists organizations in meeting the goals and effective organization of risk management, whereby the aforementioned definition contained latest expectations which the internal audit have to meet in the future. In addition, those expectations are not realized by themselves, but it is a complex process of creative development, supplementation and adaptation of existing profession of internal auditors.

New actions and circumstances violate the current inner ring which acts in internal audit.

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