References

1. Bernstein L.A. Financial Statement Analysis. Theory, Application and Interpretation. Fifth Edition. New York: IRWIN, 1993.
2. Ковалев В.В. Финансовый анализ: методы процедуры. – Москва: Финансы и статистика, 2001.
3. Панков Д.А. Бухгалтерский учет и анализ в зарубежных странах. – Минск: Экоперспектива, 1998.
4. Савицкая Т.В. Методика комплексного анализа хозяйственной деятелности. – Москва: ИНФРА – М., 2005.
5. Stickney C.P. Financial Statement Analysis. A Strategic Perspective. Second Edition. The Dryden Press, 1993.
6. Juozaitienė L. Įmonės finansai, analizė ir valdymas. Šiauliai: Šiaulių universitetas, 2000, p. 68.
7. Klimavičienė I. Apyvartinio kapitalo struktūros ir poreikio modeliavimas // Inžinerinė ekonomika, 1998, Nr. 1 (10), p. 52.
8. Mackevičius J., Įmonių veiklos analizė. Informacijos rinkimas, sisteminimas ir vertinimas. Vilnius: TEV, 2007.
9. Mackevičius J., Poškaitė D. Apyvartinio kapitalo analizės metodikos // Ekonomika, 2000, t. 52. Vilnius: Vilniaus universiteto leidykla, p. 62-79.

INHERENT RISK AND ITS EVALUATION

J. Mackevičius, Habil. dr., Professor, A. Strolaitė, Master student,
Vilnius University, Lithuania

Introduction. The audit of financial statements is identified as one of the most risky and liable activities in modern business background. The main purpose of it is to express an independent opinion on the information, contained in financial statements, certainty and fairness. Auditors sometimes fail to achieve this goal because they are unable to assess audit risks objectively, which has a direct impact on the further course of the audit and therefore the planning of the audit procedures is done not properly for prevention of disclosure of misstated material of the financial statements.

An auditor should pay more attention to the emergence of audit risk determinants and find appropriate ways to reduce them. Until now, insufficient attention of audit risk components is devoted in the literature, where one of the most important of them is the inherent risk analysis, together with the factors determining the occurrence of inherent risk.

The object of research – inherent risk assessment.

The aim of research – to analyze the inherent risk and its implications for evaluation, to trace the factors of inherent risk and to discuss factors affecting the performance of an auditor during the evaluation of the assessment of risk.

The methods of the rerearch – analysis of scientific literature, information comparison, generalization, critical evaluation, the segregation and description of most important parts.

Inherent risk and its assessment value to the process of audit

Audit risk assessment is one of the most important elements in the process of audit. In the stage of risk assessment, the auditor should obtain knowledge of accounting and internal control systems in order to plan and perform the audit, to reduce audit risk to an acceptability low level, corresponding to the objective of audit. Audit risk assessment is associated with the examination of its individual components. In the most distinguished works of science [1, 2, 3, 4, 5, 6, 7] are components of audit risk – inherent risk, control risk and detection risk.

Inherent risk can be defined as the risk where errors can be found in each financial statement, regardless of the complexity of the company, the number of transactions, complexion and diversity. What is more, the inherent risks include errors not only from accounting system, but also from the flow of all economic information.

During the analysis of inherent risk and its assessment, it is important to distinguish inherent risk assessment phase of the audit process and understand its importance to the performance of the audit (see Fig.1).

Audit methodology can be divided into the following steps: 1) assessing risks of material misstatement in the financial statements; 2) further audit procedures preparation, as the preparation of proper response to the assessed risks; 3) properly formulated preparation of audit report based on the audit evidence. Inherent risk assessment is one of the key steps in the first stage of the audit. The further audit depends on the inherent risk assessment, along with control risk, whereas taking into account assessing risk of material misstatement, further procedures of audit are selected as appropriate response to assessed risks.

The inclusion of inherent risk in the audit risk model is one of the most important concepts in auditing. It implies that auditors should attempt to predict where errors are most likely in the financial statement segments. This information affects the total amount of evidence the auditor is required to accumulate and influences how the auditor's efforts to gather the evidence are allocated among the segments of the audit [1, p. 246].

When the auditor identifies a possible distortion, the next step is to identify the company's control measures which were implemented in order to detect and correct the distortions or to prevent from further distortions. Hereby internal control weaknesses are determined, decisions are made, whether testing of internal control operating effectiveness is required.

In order to identify and assess inherent risk and to design and perform further audit procedures, the auditor should obtain the knowledge of the company and its environment. Because of inherent risk assessment requires professional judgment in de-

termining and assessing the inherent risk factors and conditions it is necessary to gather an experienced audit staff.

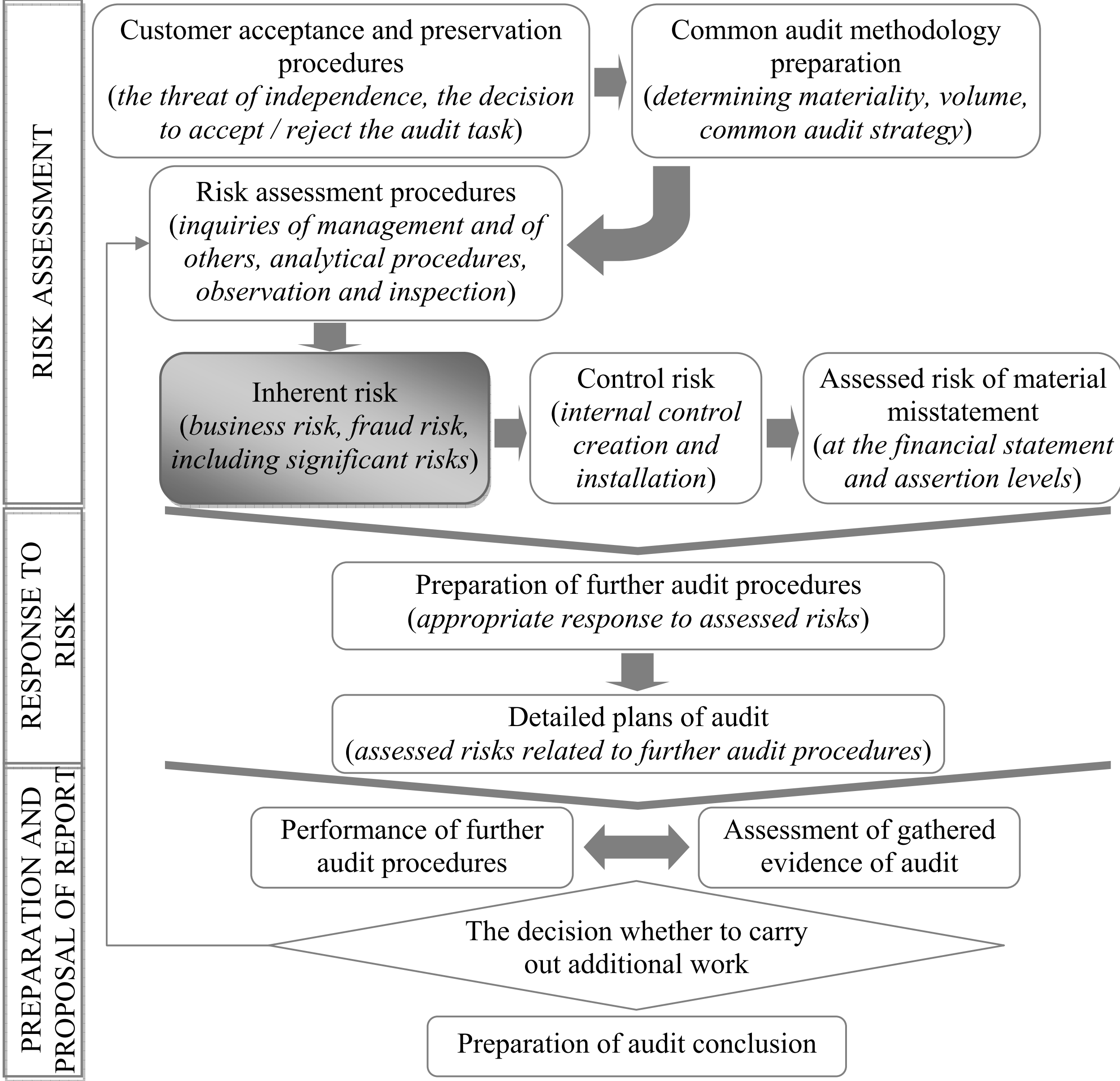

Fig. 1. The place of inherent risk assessment to the process of audit

Source*:* compiled by authors.

There are two types of inherent risk: 1) the business risk and 2) the risk of fraud (see Fig. 2).

The comprehension of business risks increases the probability of material misstatement detection. However, the auditor is not responsible for all business risk identification and assessment. Business risk is on the conditions of events, circum-

stances, actions or inactions, which may adversely affect the company's ability to achieve their goals and develop business strategies. In order to gain the knowledge of the company and its environment, and also the business risk, the auditor shall obtain an understanding of the following: 1) relevant industry, regulatory, and other external factors including the applicable financial reporting framework; 2) the nature of the entity; 3) the entity's selection and application of accounting policies; 4) the entity's objectives and strategies; 5) the measurement and review of the entity's financial performance [9].

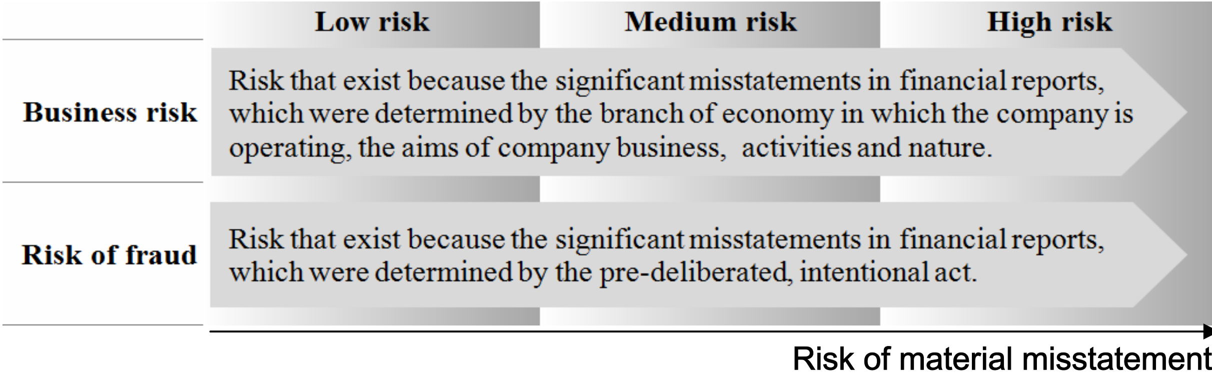

Fig. 2. Type of business risk and risk of fraud

Source: compiled by authors based on [8], 2008.

In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the material misstatement in the financial statements of the risks of fraud. The risk of fraud occurs when it is carried out by management, employees or third-party intentional acts, which seek to gain undue or unjust advantage. Deliberate distortions, such as the amount of money spent, disclosed information in the financial reports are aimed in order to deceive consumers. 240 – th International Standard on Auditing (hereinafter – ISA) (2009) fraud risk factors are classified according to two types of fraud: 1) management fraud, that means manipulation of financial statements (as an example, reports indicate higher / lower amount of income); 2) employee fraud, that means, illegal property adoption (as an example take away of company property for personal use) [10]. It should be noted that the inherent risk has always been, is and will remain, regardless of whether the company has a system of internal control or not. This risk means that errors can be common in each financial statement. There is an unwritten rule: the higher the risk, the more documents to be checked.

Inherent risk factors

The auditor cannot influence the inherent risks. The auditor should assess the risk factors instead. Inherent risk factors for the investigation should be performed

after the audit planning stage, especially in forming the audit strategy, audit plan and creating programs. However, auditors in assessing inherent risk, often fail in its determinants. In most cases, they predict only the potential errors of accounting and control systems. It is therefore appropriate to determine the inherent risk in complex, i.e. evaluating all possible internal and external factors and their size of influence [11, p. 120]. Table 1 provides examples of inherent risk factors that indicate high or low risk conditions.

Table 1

Inherent risk factors

Factors	Influence on inherent risk	
	High risk conditions	Low risk conditions
1. Macroeconomic impact for consequences of activities	Performance is highly dependent on external factors (inflation, unemployment, interest rates)	Performance is little influenced by external factors (inflation, unemployment, interest rates)
2. Technologic progress	The use of new technologies, rapid technologic progress, when a product can become outdated, and therefore stock value may be overstated	The use of common technologies, slow pace of technical progress
3. Nature of client's business and industry	Cyclical, evolving, declining or overly competitive	Stable or mature
4. The company's activities in the field continuity	Lack of working capital needed to continue the activities of company	Working capital is sufficient to continue the activities of company
5. Structure of management	Domination of one person	Management of the group of individuals
6. Management	Inadequate management, poor manager reputation, lack of experience and knowledge in management	Management is reliable and competent
7. Client motivations	Need to satisfy budget goals, existence of contingent bonus or option plans, undue emphasis on reducing tax liabilities	Budgets are readily met, management compensation is not contingent on results
8. Distortions in previous audits	Many common errors found during previous audits	Not many common errors found during previous audits
9. Results of prior-year audits	Frequent errors found in prior-year engagements	Few errors found in prior-year engagements
10. Tenure of auditor	Initial audit engagement with new client	Repeat and outgoing audit engagement
11. Size of account balance / Number of transactions	Many separate small transactions	Few large transactions

12. Nature of transactions	Unusual and complex transactions, with the lack of experience or lack of registry system knowledge, during the time of registration in registry records	Common transactions with automated input and efficient operation
13. Account balance and disclosure of information	Sums of account balances are calculated with accounting estimates that are characterized by high uncertainty in the assessment	Easily assessed amount of account balances
14. Susceptibility to defalcation	Assets easily stolen or misappropriated	Assets that cannot be easily moved or misappropriated
15. Internal accounting system	Complex accounting system	Structured accounting system
16. Control system	There is no system of internal control or it is weak	Strong control system

Source: compiled by authors based on [3, 11, 12].

Some of these risk factors affect the entire examination, others may affect only one or a number of related assertions. Inherent risk may vary depending on the financial statements and the element type of attachment, such as the sensitivity of the illegal misappropriation of assets: stocks can be easily stolen or misappropriated, compared with the equipment. On the other hand, unusual, sophisticated recording of accounting transactions require deeper knowledge in this field, so the risk is increased. High risk is common in specific operations, when on the basis of management decisions and assumptions accounting estimates are made [13, p. 50].

The subjective assessment of inherent risk depends on the fact that some of factors in Table 1 can be assessed differently. For example, a large account with frequent transactions is more likely to have mistakes because the volume of transactions implies that there is more opportunity for something to go wrong. At the same time, the client will have a great deal of experience handling a transaction that occurs frequently and is less likely to make a mistake.

Inherent risk assessment

In developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions at the level of assertions made in the financial statements, or assume that inherent risk is high for the assertion, taking into account factors relevant both to the financial statements as a whole and to the specific assertions. When the auditor makes an assessment that the inherent risk is not high, he should document the reasons for such assessment [2, p. 1121].

During inherent risk assessment, the auditor uses professional decision making, taking into account the previous experience of auditing, the control measures of company which are applied to reduce the inherent risk, and knowledge of any significant changes since the last assessment. As defined in 200 ISA (2009), inherent

risk is “the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls”. Therefore, the auditor in determining the level of inherent risk should consider all factors at two levels (see Table 2): 1) at the level of financial statements, 2) at the level of account balance and class of transactions.

Table 2

Inherent risk assessment

Level of inherent risk assessment	Factors of inherent risk assessment
At the level of financial statements	1) the integrity of management;
	2) management’s experience and knowledge;
	3) management changes during the reporting period, for example, management's inexperience may have a negative impact on financial reporting;
	4) management approach to risk and operating style;
	5) unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements;
	6) the nature of the entity’s business, for example, the potential for technological obsolescence of its products and services;
	7) factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology and accounting practices common to the industry;
	8) failures in certain areas of activity during the reporting period;
	9) communications between the departments of the company (especially if they are weak).
At the level of account balance and class of transactions	1) quality of the accounting system;
	2) financial statements are likely to be susceptible to misstatement, for example, account which required adjustment in the prior period or which involve a high degree of estimation;
	3) the complexity of underlying transactions and other events which might require using the work of an expert;
	4) account balance evaluation, for example, sums of account balances are calculated with accounting estimates;
	5) susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash;
	6) the completion of unusual and complex transactions, particularly, at or near period end;
	7) nature of transactions, for example, operations which do not include routine activity;
	8) control of transactions, for example, transactions which are completely out of control;
	9) changes in computer programs.

Source: compiled by authors based on [2, 7].

When assessing the accuracy of financial reporting, the auditor must check the honesty of management, attitude, experience and competence, management changes over the period which is audited, the nature of the business, company's and its related parties links and other factors in respect of the financial statements. This is important for predicting the financial statements falsification, conscious and unconscious errors. The auditor, when carrying balances and transaction accountings, should verify authenticity and accuracy of transactions documents, to determine whether there were uncommon transactions done, if errors are properly corrected and there is no evidence of falsification, to find out what system is used to transfer original documents to the accounting records system, if the chart of accounts and correspondence is approved and all losses property or opportunities for plunder and other factors.

The analysis of inherent risk factors suggest what determines the level of inherent risk: business management features; external factors (economic, political and competitive conditions, technological progress), accounting system and qualifications of accountants.

It is very important for the auditor to try fully and objectively assess all the circumstances and factors affecting the inherent risks. Considering the inherent risk assessments, the auditor identifies risks, regardless the internal control. Individual risk assessment prior to consideration of the internal control system helps to identify all relevant risks and provide the necessary framework for assessing management's internal control design and implementation.

Conclusion. The assessment of audit risks is one of the most important elements of the audit process. During the stage of audit risk assessment, the auditor should obtain understanding of accounting and internal control systems in order to plan and perform the audit, that audit risk would be at acceptably low level, corresponding to the audit objectives. Audit risk assessment is associated with its individual components examination (risk of material misstatement and detection risk).

Inherent risk is the risk of material misstatement at the assertion of level component. This risk can be regarded as the most important element of audit risk. From inherent risk assessment of the auditing depends further performance of audit, whereas the inherent risk assessment determined risky areas, based on further audit actions: the company's internal control systems assessment in response to the assessed inherent risks; concentration to further audit procedures in areas where the risk of material misstatement is defined; performance of further audit procedures; evaluation of the evidence and preparation of audit results.

There are two types of inherent risks: 1) the business risk and 2) the risk of fraud. In order to gain knowledge about the company and its environment, and determine the business risk associated factors that auditors should pay attention to the following areas: economic branch, maintenance and other external factors, the nature of the company, the company's accounting methods choice and application of objectives, strategies and related business risks; the company's financial performance

evaluation and review. The risk of fraud occurs when it is carried out by management, those who are responsible for governance, employees or third-party intentional act, which seeks to gain undue or unjust advantage. The factors of fraud risk are classified according to two types of fraud: 1) a fraud made by management, i.e. manipulation of financial statements; 2) a fraud made by employee, i.e. illegal appropriation of property.

In determining the level of inherent risk, the auditor should consider all factors at two levels: at the level of the financial statements and at the level of account balance and class of transactions. The risks of particular concern to the auditor: 1) the complex calculations that could be submitted incorrectly; 2) high-value stocks; 3) accounting estimates that are characterized by high uncertainty in the assessment; 4) lack of working capital to continue work; 5) declining or vulnerable branch of economy with a number of business failures; 6) development of technologies, which can make a product outdated.

References

1. Arens, A. A., Loebbecke, J. K. Auditing: An Integrated Approach. 7 ed. Upper Sand Rives: Prentice Hall, 1997, 823 p.
2. Gupta, K. Contemporary Auditing, Sixth Edition. Delis: Tata McGraw-Hill Publishing, 2005, 1530 p.
3. Knechel, W. R. Auditing: assurance and risk. 2-nd ed. South Western College Publishing, 2001, 732 p.
4. Lakis, V. Audito sistema: Raida ir perspektyvos (monografija). Vilniaus universiteto leidykla, 2007, 386 p.
5. Louwers, T. J., Ramsay, R. J., Sinason D. H., Strawser J. R. Auditing and Assurance Services (3rd ed.). New York, NY: McGraw-Hill Irwin, 2008, 865 p.
6. Mackevičius, J. Audito teorija, praktika. Monografija. Vilnius: Lietuvos mokslas, 2001, 827 p.
7. Mackevičius, J. Finansinių ataskaitų auditas ir analizė: procedūros, metodikos ir vertinimas. Monografija. Vilnius: TEV, 2009, 389 p.
8. Lietuvos auditorių rūmai. Tarptautinių standartų auditui taikymo mažų ir vidutinių įmonių auditams vadovas. Vilnius: Standartų spaustuvė, 2008, 414 p.
9. 315 – th International Standard on Auditing. Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment, 2009.
10. 240-th International Standard on Auditing. The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, 2009.
11. Mackevičius, J. Audito rizikos veiksnių vertinimas. Organizacijų vadyba: Sisteminiai tyrimai: 2005.33. VDU: Kaunas, 2005, p. 111 – 124.
12. 200-th International Standard on Auditing. Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing, 2009.
13. Jankūnaitė, R. Audito rizikos veiksniai globalioje ekonomikoje. Ekonomika ir vadyba: tarptautinės mokslinės konferencijos pranešimų medžiaga: 2007.12. VDU: Kaunas, 2007, p. 46 – 52.