RISK MANAGEMENT IN THE AUDIT OF SMES

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1. SMEs

SMEs play an essential role in modern societies, being considered the foundation of the global competitive economy. The economists see the SMEs sector as being the most important one in the Romanian economy, as well as the only sector that can bring economic revival - as the entrepreneurs are the key for economic recovery and can stimulate the strengthening of the SMEs potential, thus contributing to ensuring resources for economic growth in times of trouble.

Nowadays, however, the SMEs are in direct danger as a consequence of the economic crisis. In this period they need to carefully monitor the current expenses and potential foreseeable costs that might be caused by hazardous actions. Risk is inherent in all business fields and in all types of activities. Correctly identifying risks, evaluating them in terms of size and priority, designing mechanisms for reducing them and continuously monitoring them are the essential activities that warrant the survival of companies and create lasting value. These aspects are even more important for small and medium enterprises, which, due to their limited resources and structural particularities, are the most vulnerable to the dangers of risks.

In this context emerges naturally the visible interest of specialists for risk and its management, an interest that lies on the nature of the risk's complexity and importance in the economy of SMEs. Practice has shown the fact that for all SMEs the identification, evaluation, management and assessment of risks represents an essential element for a good performance.

It is certain that all the decision makers involved in managing small businesses recognize the existence of RISK under multiple forms and are

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aware that without an insight into its instances they have no chance in avoiding it. However, from knowledge to action there is a long way, which requires first and foremost defining risk and its complexity.

The issue can relate to the legal as well, since protecting the activities of the SMEs through the action of the financial audit is not mandatory. This is found also in the Order of the Public Finance Minister, No 3055/2009 regarding the Accounting norms corresponding to the 4th directive of the European Economic Community (EEC) and in the Accounting norms corresponding to the 7th directive of the EEC and international accounting standards, which state that: "the economic companies that shall be audited are those from Article 3, section 1, legal entities that at the date of their balance have exceeded the limits of two out of the following three criteria, henceforth called size **criteria**:

- total assets: 3.650.000 EUR
- net turnover: 7.300.000 EUR
- average employee number in the period of the financial year: 50,

and must issue annual financial statements that include:

- balance sheet;
- profit and loss account;
- report regarding changes in own capital;
- cash-flows report;
- explanatory notes to the annual financial statements"

This is the reason for which the entrepreneur in most of the cases does not use the financial audit (for financial reasons but not only), but can resort to internal audit.

In his book "**Guvernanţa corporativă şi auditul intern**" (Corporate Governance and Internal Audit), Marcel Ghiţă and the co-authors offer several **definitions to risk:**

- risk is considered as a threat of an action or of an event that is going to affect in a negative way the ability of an organization to successfully put its strategies into practice. This definition reflects the fact that risk has necessarily a negative effect on the objectives of the organization.
- risk is the chance or possibility for something to happen, something that is going to have an effect on the objectives of the company. This time, the use of the words "chance/possibility" offer a positive as well as negative connotation to the definition, suggesting

that through a good risk management it is possible to also obtain a positive effect on the organization's objectives.

- risk is defined as an incertitude of a result that takes the shape of actions or events, or a positive probability or a threat. It must be managed from the perspective of a combination between the possibility to have something happen and the impact of the realization of such a possibility. From a positive point of view, risk can present advantages or opportunities that can be ignored or taken advantage of, however, on the negative side, risk can mean disadvantages or threats.

Therefore, through the improvement of internal control, the perception on risk can turn from a possibility of loss into an opportunity for the SMEs.

In practice, risk resides from uncertainties and from the perception of these uncertainties, which means that it is necessary to analyze whether there is enough information to allow the management of risks. In the process of risk management, the possibilities are always limited, which explains why organizations are still searching for the optimum answer regarding the issue of risk management, in a certain order of priorities which results from the activity of risk evaluation.

Risk monitoring is done through internal control, which is initiated by the organization and can lead to accepting, managing and transferring risks, or in the prevention of the activities that generate them[1].

The objective of the auditor is to identify and evaluate the significantly erroneous risks generated by fraud or error, from the financial statements but also from the assertions of the company, through the analysis of the entity and its environment, including the internal control, and thus supplying a basis for the elaboration and implementation of the answers to the significantly erroneous risks.[2]

In practice, the persons responsible with risk management, are aware of the fact that it is impossible to avoid risks, and, therefore, must be preoccupied with keeping them under control, which means maintaining them at an acceptable level, one which is tolerated by the organization. This means avoiding a total elimination, since this action might cause the occurrence of other unexpected risks.

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[1] *Ghiţă, M., Sas, F., Tamaş, A., S., Briciu, S., Ghiţă, R., Dobra, B., I. – Guvernanţa corporativă şi auditul intern, Editura Aeternitas, Alba Iulia, 2009, pag. 214.*

[2] *Ghid de utilizare a ISA-urilor în auditarea întreprinderilor mici şi mijlocii Ediţia a 3 a rev., Bucureşti, ed. CECCAR, 2012, pag.320*

An aspect that must not be ignored refers to the fact that in few cases the audit is used also for the identification and elimination of risks. Basically, the audit takes place only where required by law. It is avoided based on reasons from not knowing its importance and its subsequent benefits to the classical excuse of the lack of money. In this context we can affirm that the companies that base the lack of risk management on the lack of money and that are indifferent to the addition of value that audit offers to all entities, are treading on instable grounds.

2. Types of risks

The planning of the control of objectives within an audit relies on the risk factors and their relative importance and may differ from one entity to the other.

The possibility to acknowledge risks is different, which divides them into **two categories:**[1]**:**

- ***potential risks*** – the risks that could theoretically occur when there is no control in place for the prevention or identification and correction of the errors that may happen. These risks are common to all entities.
- ***possible risks*** **-** the potential risks against which the entity does not hold any means for their limitation. Without these means, it is very likely that some undetected or un-corrected errors occur.

During the audit, the auditor aims to identify the possible risks in order to adapt the control and the occurrence of errors on the financial statements.

Usually, the auditor is faced in the case of an SME with the following categories of risks[2]:

a) ***general risks, specific to the entity, which can influence the totality of its operations***.

All companies, regardless of the sector in which they operate or their size or form of organization, hold several individual characteristics that influence their potential risks. These characteristics which differentiate a company from the other must be identified by

[1] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 72.*
[2] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 72.*

the auditor for a better control. In order to do that, the following information must be researched and analyzed:

- the company's activity and the sector in which it operates;
- its organization and structure;
- its general policies;
- the development opportunities;
- the financial and administrative organization;
- the financial policies.

This information leads to statements regarding the following general risks:

- risks concerning the financial situation of the entity;
- risks concerning the general organization;
- risks concerning the management's attitude.

b) ***risks concerning the nature of its operations***, which reflect into the annual accounts. The data presented by the accounting can be divided into three categories, each with its own risks:

- repetitive figures – result from the daily activity of the company (purchases, sales, salaries etc.) and are treated the same across the systems chosen;
- individual figures - are complementary to the above, however, their importance is emphasized at more or less equal intervals of time (when taking inventories, or during evaluations at the end of the financial year etc.). This data generates significant risk if they are not discovered in time, which makes it necessary for the auditor to get familiarized with them prior to the necessary controls.
- exceptional figures - result from operations or decisions that derive from activities such as re-evaluations, mergers, restructurings etc. In this case the risk of producing and reporting errors is extremely important as the company does not have previous criteria or comparative items or experienced personnel for these types of operations.

The more the value of a type of information is more important, the more influence the errors might have on certain financial information.

c) ***risks residing in the conception and operation of systems***, which must allow the prevention of errors or detecting the errors already produced in order to correct them.

d) ***the risk of omitting figures during the audit* -** the procedures chosen by the auditor as well as the extent of the audit and the data necessarily pose a certain degree of risk, which must be reduced as far as possible by the auditor. This risk results from the fact that it is impossible to obtain absolute insurances regarding the financial figures.

The risk of audit is determined by the existence in the financial situations of certain significant errors and, when they are not identified by the auditor, the audit evaluation is erroneous. The auditor must design a working program that ensures in a reasonable manner that there are no significant risks in the financial situations, and that limit the audit risk to an acceptable minimum.

Therefore, the auditors must possess and extended knowledge regarding the potential factors of risk and must identify the potential risk that reside in the particularities of each company. Their opinion is therefore more conclusive, and the advice for the audited company is more pertinent. The extent of the above risks can be identified by the auditor through their "relative importance", defined starting from the value or nature of an inaccuracy or irregularity which is part of a financial statement. It alone or in addition to others can influence the reason or the decision of a person that makes statements based on this improper information.

The irregularities comprise all the actions that contravene to[1]:

- the law or the norms concerning companies;
- accounting principles or procedures;
- statutory norms;
- the decisions of the company's shareholders general assembly;
- the decisions of the administration committee.

The inaccuracies refer to the accounting and legal interpretation or biases of a fact, which contravene to the reality, such as[2]**:**

- calculation errors;
- recording errors;
- inaccuracies in presenting the annual accounts.

[1] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 78.*

[2] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 78.*

Once discovered these irregularities or inaccuracies, the auditor goes on to making the necessary checks in order to assess their nature and importance. He or she will not inform the decision makers (managers, directors, etc) **unless when**:

- they are directly connected to the object of its mission or are concerned with the law of commercial companies, or the tax requirements, or the capital markets law;
- they have a sufficient relative importance.

The auditor will have to take note of the notion of relative importance, and will therefore, identify[1]:

- the significant systems, in which the risks associated to the internal audit are as low as possible;
- the significant accounts, which will be examined more rigorous than the others;
- the degree of significance, which offers the possibility to decide whether the errors or inaccuracies found must be corrected or not, thus being able to formulate a pertinent statement.

3. Significant systems, fields and accounts

Ever since the beginning of the activity, the auditor will try to identify the significant areas and fields in which errors or inaccuracies can occur, and where their influence can have a significant consequence over **the accounting and financial statements and not only.** All elements that can have an influence over the financial statements and over their users can be considered significant.

The significant fields can be **classified into[2]:**

- ***significant systems*** – any system that exists in the company and that is involved in the recording and transcription of repetitive operations, when their cumulated value has a large weight in the financial situations. The systems common to all companies are: purchases - suppliers; sales - clients; payments to employees; treasury; production - stocks.
- ***significant accounts*** **-** the accounts whose value represents a large part of hte financial statements, or those which, by their nature,

[1] *Stoian, A., – Audit financiar-contabil, www.biblioteca-digitala.ase.ro, cap 3, pag 17.*

[2] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 81.*

may represent a large part of the statements, and may hide errors or inaccuracies whose relative importance is directly connected to the regularity of accounting, having a significant influence on the financial statements.

The auditor must take the following **aspects** into account when identifying the significant accounts[1]:

- the values of the ongoing production higher during the year than at the end of the financial year;
- the provisions accounts are influenced directly by the management's own forecasts and thus lie in the category of significant accounts;
- risk bearing accounts (adjustments accounts, accounts affected by a legal change);
- the accounts that present apparent anomalies as compared to the previous year or contrary to the role of the account, thus bearing hints of errors that must be taken into account by the auditor.

Significant findings can be done by the auditor throughout the financial year, as well as in various stages of the preparation of the yearly accounting reports: evaluation, presentation or verification, **as follows**[2]:

a) findings regarding the content of a specific evaluation, which identify:
- the erroneous calculation of certain figures;
- inconsistencies regarding the assessment of certain figures;
- the application of an accounting procedure that does not comply with accounting practices;

b) findings regarding the presentation of an asset:
- the use of a general name;
- the disregard for certain important aspects;
- the erroneous grouping of certain figures;

c) findings relating to the examination of an element, in which case the auditor concludes that the checks performed are not satisfactory due to a faulty internal control or documents that do not provide sufficient evidence.

[1] *Stoian, A., – Audit financiar-contabil, www.biblioteca-digitala.ase.ro, cap. 3, pag. 18.*

[2] *Toma, M. – Iniţiere în auditul situaţiilor financiare ale unei entităţi – Ediţia a III-a revizuită şi adăugită –, Editura CECCAR, Bucureşti, 2009, pag. 84.*

4. The evaluation of internal control and the audit risk

The auditor performs at least one preliminary evaluation of the internal control, which allows him or her to have a general view on the inherent and control risks association with the audited activities and to assess whether the controls are efficient and realistic in order for the auditor to rely on their results and conclusions. Before granting credibility to the internal control system, it is necessary to evaluate its efficiency in practice through tests of conformity. The quantity of audit evidence required to prove the conformity to an evaluation criterion is directly proportional to the risk that the auditor formulates the opinion regarding that criterion, and the risk that in reality there exists a higher misalignment with the criterion, which is covered by the importance of the audit report to the users. This risk is called **global audit risk.**[1]

It is necessary to quantify these consequences, or if this is not possible, to establish certain limits within which they should fall. It remains the auditor's choice whether to state or not in the report the facts that have an indirect influence over the financial statements examined, but which may generate consequences over the future financial years.

5. The audit risk and the process of risk management

When the financial situations contain erroneous material information, the auditor must allocate a certain risk to a faulty opinion. The audit risk is defined as the statement of erroneous conclusions and recommendations for the evaluated company starting from significant errors in the financial statements. The audit risk has the following three **components:**[2]:

a) ***the inherent risk*** – all the risks that affect an organization, caused by an insufficient internal control. It refers to the possibility that a category of operations hold material errors, which can appear individually or from cumulated errors from various categories of operations, assuming that the internal controls did not take place.

b) ***the control risk*** **-** determined by the deficiencies of the internal control system, in direct connection to the control

[1] *Jucan.C., Petraşcu D.,Problematica de ansamblu a controlului şi auditului intern, Ed. Alma Mater, Sibiu, 2011, pag. 125.*

[2] *Menu, M., Afanase, C., Panaitescu, I., Vilaia, D. – Audit financiar, Editura Tehnica-Info, Chişinău, 2009, pag. 61.*

environment in which the organization operates, as well as the control activities which were implemented, which must be designed so as to reduce risk and maintain it at a tolerable level. This is the risk of material error which may occur within a certain operation, either individually, or cumulated with errors that belong to other categories of operations, and cannot be prevented, detected or corrected in time by the internal control.

c) ***the risk of overlooking***: the risk that the procedures used by the auditor do not detect the errors found in a category of operations, which can be found isolated or together with other categories of operations. It cannot be eliminated completely, regardless of the procedures and techniques used.

The audit risk is usually determined through: statistic surveys; the matrix of the financial audit risks; the matrix of the risks synthesis.[1]

Risk management represents an essential component for the success of an SME, because it determines the growth of faith from the external factors of the SME in its ability to fulfill its objectives.

The process of risk management requires key activities in a logical succession, **as follows**[2]:

- ***risk identification***, which involves all the parties that have experience and responsibility and which can help identifying and recording all the risks;
- ***risk evaluation***, for the risks that have been identified, based on their probability and impact;
- ***risk* management** requires knowledge on their importance and the development of management strategies. The purpose of this activity is to ensure the limitation of the key risks;
- ***risk assessment* requires** the supervising of the entire risk management process. The result of this activity should contribute to the permanent update of the risk management strategy.

6. Error and fraud in audit

Error, in the specialized literature[1] is defined as **an unintentional mistake: mathematic or accounting mistake** in the accounting recordings

[1] *Jucan C, Petraşcu D, Op. Cit pag.126*

[2] *Ghiţă, M., Sas, F., Tamaş, A., S., Briciu, S., Ghiţă, R., Dobra, B., I. – Guvernanţa corporativă şi auditul intern, Editura Aeternitas, Alba Iulia, 2009, pag. 230.*

and figures, **the omission or mistaken interpretation** of the economic-financial phenomena and the **flawed application of accounting policies** (methods, principles, rules).

The factors that influence the risk of occurrence of errors and fraud are: deficiencies in the design and operation of internal control and accounting systems, the integrity and competence of the company's management, the unusual pressures within the audited company, the unusual transactions (operations), the problems occurred in the search for sufficient audit evidence, special conditions that favour the risk of fraud and error in the case of using computer systems.

The audit must take into account the potential impact of a possible fraud on the financial information and must be able to perform the required changes to the audit plan, and even use additional audit procedures which comprise: the assessment of the efficiency of the control for the prevention and detection of fraud and misalignments, the assessment of the size of the presumed fraud, analytical procedures used to test the existence of fraud, the interview technique applied to those who are suspected of fraud. When the auditor identifies the existence of a deviation, other than fraud, he or she must take account of this deviation and the circumstances in which it took place and will use all necessary effort to obtain all possible and sufficient information in order to allow the evaluation of the effects on the financial statements, taking into account: the possible financial consequences, the manner in which they are found in the financial statements, the size of the financial consequences and their significance for the legality of the operations. As for the responsibility to report error and fraud, as a general principle, the auditor must know the internal and external procedures of reporting used by the audit company in case of presumed fraud or errors. The knowledge of these procedures, and the timely consultation with the competent authorities (internal and external), will ensure that the investigation of the presumed fraud takes place in a correct manner, without the risk of compromising the administrative and legal procedures that may follow.[2]

As a conclusion of the above, in practice, there are two major risk classes: the risk inherent to the activity and the risk of fraud. This does not exclude the possibility that in some situations a risk may fall into both

[1] *Boulescu M.şi colectiv,2001, p. 53-54*

[2] Jucan C., Petraşcu D., Op. Cit. pag.126-127.

categories. The category "risks inherent to the activity" includes apart from the risks regarding erroneous financial figures and risks for the general activity also risks generated by instances, events, circumstances, actions or lack of significant actions, which can negatively impact the ability of the entity to reach its objectives and to put into practice its strategies. However, the category risk of fraud relates strictly to events or conditions that represent an incentive or a pressure to commit fraud or offer the opportunity to commit fraud.

The awareness of the auditor regarding the factors of risk of fraud and those regarding the general activity is a step towards the possibility to identify the risks of significant concealment.

It is important to underline the fact that there are many situations when the audit is avoided from various reasons:

- not knowing the law;
- avoidance of costs or avoidance that external persons (auditors) have contact with the financial statements of the company;
- or even the fear of identification of certain drawbacks or illegal actions, which all lead to insecurity and risk.

Therefore, the auditor is not able to identify or evaluate all the possible risks inherent to the activity, or, put differently, in a risky statement, we do not have the conviction that it is desired to eliminate each and every one of them.

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