EXPLAINING THE AUDIT RISK AND ITS COMPONENTS: A COMPARATIVE CASE-STUDY BASED ON AUDIT REPORTS

ALINA VOICULESCU
STUDENT PHD, "1ST OF DECEMBER 1918" UNIVERSITY, ALBA IULIA, ROMANIA
e-mail:alina_voiculescu@yahoo.com
SORINA SIMONA BUMBESCU
STUDENT PHD, "1ST OF DECEMBER 1918" UNIVERSITY, ALBA IULIA, ROMANIA
e-mail:sorina.bumbescu@yahoo.com

Abstract
The players activating in the post-recession business environment have to and begin to be more and more prudent and attentive to any sign of human errors, uncertainty, lack of objectivity, attempt of fraud which may occur when financial statements are prepared, in their own case or in the case of their trade clients/suppliers, debtors, business partners, in general. Auditors thus became the mediators between the producers and the users of accountant information, using their high theoretical training, authority, competence and independence as pledge for the fairness of the financial statements and for the compliance with the Law. But even their reports are subject to uncertainty, therefore the author considered useful to approach in the current paper the issue of risk in financial audit, by use of a study-case of several audit reports, in order to explain and exemplify it and to highlight the difference between its components' evaluation.

Key words*: audit risk, inherent risk, control risk, un-detection risk, internal control*

JEL Codes*: M42, G32*

1. Introduction

Etymologically, the word "audit" is based on the Latin "AUDIRE", meaning "to listen". Without knowing the exact date of its appearance or geographical location, over time, the term came to acquire the meaning of accountancy verification or inspection. By the eighteenth century audit was required by kings, church and state in order to punish fraud and to protect the institution's heritage and the auditors were chosen from among the priests. Since nineteenth century, as states and judicial courts took the place of the old social classes, auditors started to be chosen amongst the best accountants and since then things have evolved continuously, nowadays auditors, as specialists with high theoretical training, with authority and competence, are being called experts. The activity of expertise appears and "it brings together professionals with theoretical and practical knowledge who, based on contracts signed with third parties, are investigating the financial statements" (Stoian, A., 2001).

The result of the accountancy is represented by the accounting information and its objective is to obtain a true and fair view of the financial statements that comprise the "balance sheet, income statement, cash flow statement and notes to annual accounts." (OMF no.403/22.04.1999) Still, producers of accounting information must face an increasingly complexity of accounting work, due to the increased diversity of economic activities, development of capital markets, banking institutions, which entails an increased risk of processing, interpretation and evaluation errors; In addition, the possibility for lack of objectivity appears, given that producers of information are directly involved in company's operations.

According to the International Accounting Standards Committee (IASC) accounting information must satisfy informational needs of complex users, namely: present and potential investors, employees, financial creditors, suppliers and other trade creditors, customers, the government and its institutions, the public. These users have interests in accounting information often different from those of the information producers. International Accounting Standard no. 1 shows that the "financial information is intended to provide a useful information for economic and financial decisions". Therefore, between producers and users of accounting information it is necessary to place a professional, an expert accountant, with significant practical experience, with recognized authority and competence and, most importantly, with independence: the Auditor. But regardless if it is internal or external, audit is subject to audit risk, "the risk that the auditor gives an inappropriate audit opinion when the audited financial statements are significantly misstated" (IAS 400, 1999). To reduce this risk, the auditor follows procedures which allow him to obtain a reasonable degree of certainty, to consider, according to IAS 400, that "the audit risk was reduced to an acceptably low level". (IAS 400, 1999)

This paper aims to highlight, explain and exemplify the audit risk and its components: inherent risk, control risk and detection risk and the relationship between them. It will include a theoretical part, comprising the state of knowledge and research directions in the field, but also specific legislation and, as a case study, audit reports for three companies in Alba county, operating in different sectors with different management styles, different ways of internal control, in order to identify the different ways to assess risk, based on professional rationalism. Interpretation of the results of this case study and author's opinions will be subject of the chapter Conclusions at the end of the article.

2. Literature review. International legislation

From the European accounting legislation point of view, audit risk is regulated by the International Standard on Auditing 400: ISA 400, "Risk Assessment and Internal Control". International Standards on Auditing (ISA) are used in auditing financial statements and adapted as necessary, in auditing other information and related services. According to ISA 400, the audit risk is "the probability that the auditor gives an inappropriate audit opinion if the financial statements are significantly misstated and has three components: inherent risk, control risk and detection risk" (ISA 400, 1999).

To fully understand these risks, the probability that they will occur and how they can be assessed, it is first necessary to refer to the concept of internal control. Same Audit Standard 400 provides rules to support understanding of the accounting system and internal control procedures implemented by the audited company. By doing this, the accounting system appears as "a set of axioms, principles, norms and rules of assessing an entity, in which economic and financial transactions are processed through the accounting technical instrumentation. The accounting system identifies, correlates, calculates, analyzes, records and provides all the information about the transactions or events that have taken place in a period of time". (Stoian, A., 2001).

Different authors, institutions or organisms give different definitions to the concept of internal control:

- INTOSAI (International Organization of Supreme Audit Institutions), referring to governmental institutions defines the internal control as "a management tool used to provide reasonable assurance that management's objectives are being achieved. Therefore, responsibility for the adequacy and effectiveness of the internal control structure rests with management. The head of each governmental organization must ensure that a proper internal control structure is instituted, reviewed, and updated to keep it effective" (www.intosai.org);

- According to ISA 315, the internal control is "the process designed and performed by those in charge with government, management and by other employees, in order to deliver a reasonable assurance for achieving objectives related to financial reports' credibility, activity's efficiency and compliance with applicable legislation" (ISA 315, 1999);

- COSO (Committee of Sponsoring Organizations of the Treadway Commission, USA) gives internal control the following definition: "Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1.Effectiveness and efficiency of operations.2.Reliability of financial reporting. 3. Compliance with applicable laws and regulations." (www.coso.org)

- Prof. Adriana Tiron Tudor defines internal control as "a system developed in order to properly control the financial and operational procedures of every entity. It may offer a reasonable but not absolute assurance that all assets are protected and that transactions are authorized and properly recorded". (Tiron Tudor, A., 2009)

According to ISA 400, the internal control system comprises the control environment and the control procedures system of the company. Control environment refers to the importance the management grants to the internal control, to the management style and strategy, to entity's organizational chart and to the way the internal audit is organized. Control procedures complement the control environment in order to achieve the control specific objectives of the entity.

Turning to the components of audit risk, the first of these, namely the inherent risk occurs when it is assumed that there were no related adjacent internal controls and it represents "the susceptibility of an account balance or class of transactions to contain a misstatement that could be significant individually or when aggregated with misstatements in other balances or classes of transactions"(ISA 400, 1999). Assessing inherent risk at financial statements level requires the evaluation of several factors such as: integrity, experience and knowledge of the management, changes in management, exceptional pressure exerted on management (insufficient capital, negative experiences in the business sector, etc..), nature of activity and factors affecting the industry in which the entity operates (competition, consumer demand, common accounting practices per sector, etc.). At account balances and classes of transactions level, are taken into account in assessing the inherent risk: financial statement accounts likely to be susceptible to distortion (accounts requiring adjustments or involving a high estimate), the complexity of the main transactions or that of other events that may require using the services of an expert, the level of professional judgment involved in determining the account balance, the susceptibility for the assets to be lost or of embezzlement (cash), completion of an unusual and complex transaction, especially close to the end of the financial year.

The control risk is, according to ISA 400, "the risk that a misstatement that could occur in an account balance or class of transactions and that could be significant individually or when aggregated with other misstatements, will not be prevented or detected and corrected at proper moment, by the accounting and internal control” (ISA 400, 1999). The auditor assesses control risk as high, medium or low. In assessing control risk, two stages will be completed:

- Preliminary assessment, in which is verified the effectiveness of the accounting and internal control in preventing and detecting significant misstatements. Usually, following preliminary assessment the risk level is set as high unless the auditor is able to identify internal controls relevant to the assertions which could prevent or detect and correct a significant misstatement and plans to perform tests of internal control to support the assessment.
- The final assessment of control risk is based on the results of control tests. These may include: inspection of justifying documents of transactions and of other events, in order to gather audit evidence certifying that internal control systems are functioning properly (i.e. verifying that a transaction has been authorized), investigation and observation of internal controls that have left no audit trail or reissue internal controls (i.e. reconciliation of bank accounts). Any assessment of control risk at a level less than high should be tested by the tests of controls as the more reduced evaluation of risk control is, the more evidence must be made by the auditor to support.

Inherent risk and control risk belong to the entity, without being dependent on the audit process, and the auditor's role is to assess the risk of significant misstatement, as a basis for further audit procedures. ISA 400 recommends combined assessment of inherent and control risk, due to the fact that often the management reacts to inherent risk situations by designing accounting systems and internal controls, resulting in a high degree of inter-relationship between them.

The third component of audit risk, the undetection risk is the only part that is under auditor’s control. It appears as a measure of the effectiveness of the audit process and of how it is applied by the auditor and represents the risk that the auditor will not detect a misstatement that exists in an assertion that could be signficant isolated or if it is aggregated with other misstatements. "Undetection risk can not be reduced to zero because the auditor does not examine, as a rule, all classes of transactions, all account balances [...]". (Tiron-Tudor, A., 2009) And even if the auditor examines 100% of account balances or classes of transactions, most audit evidence is persuasive rather than conclusive.

Synthetizing, „inherent risks are those risks which emanate as a result of the nature of the business entity, control risks are those risks resulting from reliance on the internal controls functioning within the business whilst detection risk is the risk that the auditor would not be able to detect material misstatements during procedures aimed at detecting such. The audit risk models is denoted by the following equation:

$$AR = IR * CR*DR \quad (1)$$

where AR represents audit risk, IR represents inherent risk, CR represents control risk and DR represents detection risk” (Ojo, M., 2006).

Following the same judgment, „detection risk shall be inversely proportional to the risk inherent and control risk and directly proportional to the acceptable audit risk. The audit risk model used in planning the audit shall be:

Detection risk planned = Acceptable audit risk / (Inherent risk x The control risk) (2)”

(Moraru, M., Dumitru, F., 2011).

Fearnley, Beattie and Brandt (2005) studied the impact of audit risk on auditor independence and his ability to resist to auditee pressure. Thus „if IR * CR is weak, the auditor could, owing to the fact that the detection risk is weak, reduce his accounts controls (substantive tests), it could in this case accept an auditee's aggressive reporting practice. On the other hand, if IR * CR is medium or high, the auditor should carry out an important work in the form of substantive tests. In this case, the auditor must be careful and conservative in the examination of the methods practiced by the auditee.” (Fearnley, S., Beattie, V., Brandt, R., 2005)

3. Data and Methodology

ISA 400 indicates that there is an inverse relationship between undetection risk and the combined level of inherent and control risk. If the inherent and control risks are high, undetection risk should be acceptably low, in order to reduce the audit risk to an acceptably low level and vice versa, where the inherent and control risk are low, undetection risk may be higher, reaching however an acceptably low level of audit risk (Table no.1).

Table no.1. Ilustration of the relationship between audit risk’s components. The shadowed portions from the table represent the undetection risk

		Assessment of control risk by the auditor		
		High	**Medium**	**Low**
Assessment of inherent risk by the auditor	**High**	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

Source: ISA 400

In order to perform risk assessment, will be taken into account the control environment, the inherent risk for each category of transactions, control risk for each category of transactions and minimizing overall the audit risk by analyzing financial statements, management reports, budgets, etc. If the control environment is weak, the auditor can not rely on internal controls and he will then assess control risk as high, for each class of transactions. If the control environment is appropriate, Risk assessment will consider the inherent risk for each category of transactions, control risk for each category of transactions and minimize overall audit risk by analyzing financial statements, management reports, budgets, etc. If the control is weak, the auditor can not rely on internal controls and then assess control risk as high, for each class of business. If the control is appropriate, than each category of transactions will be assessed. Throughout the audit process, the auditor aims risks likely to arise which may affect the fairness of the opinion issued. Depending on the identified risks, the auditor shall determine the duration of the audit, in the sense that the higher the risk is for an activity, the more time is allocated to verification of that activity.

We examined the reports of three different independent auditors made for three different companies in two different periods, based on the financial statements at December 2012 and December 2013. We will replicate the reports synthetically and, in order to respect the confidentiality of the audited companies we will call them X, Y and Z, as we will name the audit companies A, B and C (Table no. 2, 3, and 4).

Table no.2. Audit report issued by Auditor A for company X for 2012 and 2013 financial exercises

Audit report for company X, year N-1	**Audit report for company X, year N**	
Auditor: A CUI / J / address: , tel., fax. CAFR Member, Authorization no. xx/xx.xx.xxxx Independent Financial Auditor's Report Report on unconsolidated financial statements: 1. We have audited the attached unconsolidated financial situations for company X SRL ("The Company", for the completed financial exercise, which include: a. Balance-sheet; b. Profit and Loss Statement; c. Equity Changes Statement; d. Cash-flow Statement; e. Explanatory notes for the annual statements. The mentioned unconsolidated financial statements refer to:		
	Year N-1	Year N
Fix assets	11.127.056 ron	23.428.549 ron
Current assets	24.699.629 ron	29.545.574 ron
Short-term debts	11.047.436 ron	17.883.658 ron
Total assets less current debts	24.860.189 ron	35.187.170 ron
Cash	2.522.754 ron	2.241.188 ron
Long-term debts	2.645.352 ron	6.729.752 ron
Deferred income	-	-
Subscribed and paid capital	1.968.000 ron	1.968.000 ron
Total equity	22.214.837 ron	28.457.418 ron
Net sales	51.071.855 ron	61.838.504 ron
Net result (profit)	6.446.545 ron	6.242.581 ron
Management's responsibility related to unconsolidated financial statements 2. The Company's management is responsible for preparation and fair presentation of unconsolidated financial statements in compliance with Accountancy Law no. 82/1991, republished and with the MFP no. 3055/29.10.2009 for approving the Accountancy Regulations according with European Directives and also for the internal control the company considers necessary in order to prepare unconsolidated financial statements which don't contain significant misstatements, due to fraud or error. Auditor's responsibility: 3. Auditor's responsibility is to express, based on performed audit, an opinion for this unconsolidated financial statements. The auditor performed the audit according with audit standards adopted by the Romanian Chamber of Financial Auditors. These standards require the auditor to respect the ethical requirements, to plan and to perform the audit in order to obtain a reasonable assurance that the financial statements do not contain significant misstatements. 4. Un audit consists in performing procedures in order to obtain audit probes regarding the amounts and information presented in the unconsolidated financial statements. The selected procedures are depending on auditor's professional judgment, including evaluation of risks of significant distortion of the unconsolidated		

financial statements, due to fraud or error. In evaluation of these risks, the auditor takes in consideration the internal control relevant for preparation and fair presentation of the unconsolidated financial statements of the Company in order to establish the audit procedures relevant in the given conditions, but not for the purpose of expressing an opinion on the efficiency of Company's internal control.

a. An audit also includes the evaluation of accounting policies adequacy level and of the reasonability of the accounting estimations issued by the management, and also for assessing the presentation of unconsolidated financial statements, taken as a whole.
b. We consider the audit probes that we obtained as sufficient and adequate for issuing the base of our reserved opinion.

Basis for the reserved opinion:

Year N-1	Year N
5.The audit opinion expressed on the financial statements was modified (influenced) by some limitations of audit applicability area, imposed by the following circumstances: a.The Company didn't organize internal audit for the completed financial exercise; b. The tangible assets consisting of lands, registered in the account 211: "Lands", with an outstanding at 31.12.2012 of 945.657,70 ron are not presented at fair value, except for the ones acquired in the current financial exercise in total value of 30.000 ron. Also, the assets mentioned in the account 213: "Machinery, vehicles, animals and plantations", with an outstanding at 31.12.2012 of 7.167.565,08 and account 214 "Office equipment and other tangible assets", with an outstanding of 246.103,89 ron are presented at historical value and not at fair value, except for the ones acquired in the previous financial exercise, in total amount of 413.892,80 ron. The assets from these accounts hold 33,30% from total assets at 31.12.2012. c. The outstanding of the account 4118 – Uncertain clients at 31.12.2012 was of 441.523,40 ron, on which adjustments for depreciation of receivables were made in 2012, in amount of 24.311,75 ron. These adjustments, cumulated with previous outstanding of the account 491 "Adjustments for depreciation of receivables", have a final outstanding at 31.12.2012 of 407.273,49 ron, compared to total uncertain clients of 441.523,40 ron. To be mentioned that for the difference of 34.249,91 ron additional adjustments should have been made on account of expenses, diminishing the result of the exercise. d. The account 461 "Sundry Debtors" has an outstanding of 7.774,90 ron, which represent uncertain receivables older than 1 year. To be mentioned that the Company should have made adjustment for depreciation of receivables in the account 496 "Adjustments for depreciation of receivables from sundry debtors" in amount of 7.774,90 ron. e. Although confirmation letters for confirming the receivable amounts were sent to debtors, to be mentioned that confirmations were obtained only for 21,22% of the outstanding for the account 411 "Clients" at 31.12.2012, in total amount of 11.928.140,63 ron.	5.The audit opinion expressed on the financial statements was modified (influenced) by some limitations of audit applicability area, imposed by the following circumstances: a. The Company didn't organize internal audit for the completed financial exercise; b. The tangible assets consisting of lands, registered in the account 211: "Lands", with an outstanding at 31.12.2013 of 1.189.808,20 ron are not presented at fair value, except for the ones acquired in the current financial exercise in total value of 244.150,50 ron. Also, the assets mentioned in the account 213: "Machinery, vehicles, animals and plantations", with an outstanding at 31.12.2013 of 14.194.404,23 ron and account 214 "Office equipment and other tangible assets", with an outstanding of 323.884,84 ron are presented at historical value and not at fair value, except for the ones acquired in the previous financial exercise, in total amount of 7.592.908,00 ron. The assets from these accounts hold 23,32% from total assets at 31.12.2013.

Reserved opinion, for both years:

6. In our opinion, except for the possible effects of the adjustments mentioned in paragraph 5, the unconsolidated financial statements for the financial exercised completed at 31.12.2012 were prepared in all significant aspects in compliance with the Accounting Law no. 82/1991, republished, and with the MFP no. 3055/29.10.2009 for approving the Accountancy Regulations according with European Directives.

Emphasis of issues:

Year N-1	Year N
7. Without expressing additional reserves, we draw attention on Note 10 – Other information from the unconsolidated financial situations, which provides information on the contracted credits and assets brought as collateral. 8. Also, we draw attention on Note 6 – Principles, policies and accounting methods, which include mentions about changing the amortization method for fix assets, starting with 2012.	7. Without expressing additional reserves, we draw attention on Note 10 – Other information from the unconsolidated financial situations, which provides information on the contracted credits and assets brought as collateral. 8. Also, we draw attention on Note 6 – Principles, policies and accounting methods, which include mentions about changing the amortization method for fix assets, starting with 2012, therefore, amongst Machinery, both line method and accelerated method are used.

Other issues:
9. We consider that the principle of activity's continuity was respected.
10. This independent auditor's report is addressed exclusively to Company's shareholders. Our audit was performed in order to be able to report to Company's shareholders aspects which should be reported in a financial audit report, and not for other purposes. As permitted by law, we don't accept and don't assume responsibility other than towards the Company and its shareholders, for our audit, for the report on the unconsolidated financial statements, for the report on conformity and for the issued opinion.
11. In compliance with OMFP no. 3055/2009, we read the administrators report attached to the unconsolidated financial situations. The administrators report is not a part of the unconsolidated financial statements. In the administrators report we didn't identify financial information significantly inconsistent with the information presented in the unconsolidated financial statements.

Signature,
Place, Date

Source: own synthesis and translation of A Auditor Report

Table no.3. Audit report issued by Auditor B for company Y for 2012 and 2013 financial exercises

Audit report for company X, year N-1	**Audit report for company X, year N**

Auditor: B
CUI / J / address: , tel., fax. CAFR Member, Authorization no. xx/xx.xx.xxxx

To Shareholders of Y SRL
Sebes, Romania

Independent Auditor's Report

Report on financial statements:
1. We have audited the financial situations for company Y SRL ("The Company"), for the completed financial exercise, which include Balance-sheet for the completed exercise, the Profit and Loss Statement, Equity Changes Statement and Cash-flow Statement and a summary of the significant accountant policies and other explanatory notes. The mentioned financial statements refer to:

	Year N-1	Year N
Net Assets/Total Liabilities:	11.894.868 ron	15.475.641 ron
Net result (profit)	2.102.202 ron	3.175.147 ron

Management's responsibility related to financial statements
2. The Company's management is responsible for preparation and fair presentation of financial statements in compliance with the MFP no. 3055/29.10.2009 and also for the internal control the company considers necessary in order to prepare financial statements which don't contain significant misstatements, due to fraud or error.
Auditor's responsibility:
3. Auditor's responsibility is to express, based on performed audit, an opinion for this financial statements. The auditor performed the audit according with audit standards adopted by the Romanian Chamber of Financial Auditors. These standards require the auditor to respect the ethical requirements, to plan and to perform the audit in order to obtain a reasonable assurance that the financial statements do not contain significant misstatements.
4. Un audit consists in performing procedures in order to obtain audit probes regarding the amounts and information presented in the unconsolidated financial statements. The selected procedures are depending on auditor's professional judgment, including evaluation of risks of significant distortion of the unconsolidated financial statements, due to fraud or error. In evaluation of these risks, the auditor takes in consideration the

<table>
<tr><td colspan="2">internal control relevant for preparation and fair presentation of the unconsolidated financial statements of the Company in order to establish the audit procedures relevant in the given conditions, but not for the purpose of expressing an opinion on the efficiency of Company's internal control. An audit also includes the evaluation of accounting policies adequacy level and of the reasonability of the accounting estimations issued by the management, and also for assessing the presentation of unconsolidated financial statements, taken as a whole.
5. We consider the audit probes that we obtained as sufficient and adequate for issuing the base of our unreserved opinion.
Opinion without reserves:
6. In our opinion, the financial statements fairly present, under all significant aspects, the financial position of the company Y SRL for the completed financial exercise, and also its financial performance, cash-flow for the year, in compliance with OMF no. 3055/2009 and with the accountant policies described in the notes to the financial statements.
Other issues:</td></tr>
<tr><td>Year N-1</td><td>Year N</td></tr>
<tr><td>7. This report is addressed exclusively to Company's shareholders. Our audit was performed in order to be able to report to Company's shareholders aspects which should be reported in a financial audit report, and not for other purposes. As permitted by law, we don't accept and don't assume responsibility other than towards the Company and its shareholders, for our audit, for this report or for the issued opinion.
8. The attached financial statements are not intended to present financial standing, result of transactions and complete set of notes to the financial statements, according to accountant regulations and principles accepted in countries and jurisdictions other than Romania. Therefore, the attached financial situations are not prepared for the use of individuals who don't have knowledge of the Romanian accountant and legal regulations, i.e. OMFP 3055/2009.
9. The financial situations for the completed year 2012 were also audited by another auditor which in his report submitted on 11st of April 2013 issued an opinion without reserves.</td><td>7. This report is addressed exclusively to Company's shareholders. Our audit was performed in order to be able to report to Company's shareholders aspects which should be reported in a financial audit report, and not for other purposes. As permitted by law, we don't accept and don't assume responsibility other than towards the Company and its shareholders, for our audit, for this report or for the issued opinion.
8. The attached financial statements are not intended to present financial standing, result of transactions and complete set of notes to the financial statements, according to accountant regulations and principles accepted in countries and jurisdictions other than Romania. Therefore, the attached financial situations are not prepared for the use of individuals who don't have knowledge of the Romanian accountant and legal regulations, i.e. OMFP 3055/2009.</td></tr>
<tr><td colspan="2">Report on conformity of administrators report on financial statements
In compliance with OMFP no. 3055/2009, article 318, point 2, we read the administrators report attached to the financial situations. The administrators report is not a part of the financial statements. In the administrators report we didn't identify financial information significantly inconsistent with the information presented in the financial statements.

Signature,
Place, Date</td></tr>
</table>

Source: own synthesis and translation of B Auditor Report

Table no.4. Audit report issued by Auditor C for company X for 2012 and 2013 financial exercises

<table>
<tr><th>Audit report for company X, year N-1</th><th>Audit report for company X, year N</th></tr>
<tr><td colspan="2">Company Z SRL
Alba Iulia

Financial Auditor: C
CUI / J / address: , tel., fax. CAFR Member, Authorization no. xx/xx.xx.xxxx

Financial Auditor's Report

1. In accordance with the financial audit contract no. xx, we have audited the annual financial statements for company Z SRL ("The Company"), for the completed financial exercise, which include, in compliance with OMFP 3055/2009: the balance sheet, the profit and loss statement, equity changes statement and cash-flow statement and explanatory notes to the financial statements. The auditor also considered the stipulations of Law</td></tr>
</table>

82/1991, of Law 441/2006 which amends and completes Law 31/1990 and the stipulations of Law 26/1990 regarding Commerce Registry.

2. The responsibility for the financial statements belongs to the management of the company Z SRL. Our responsibility is to express opinion on these financial statements, based on the performed audit.

3. These financial statements were completed in compliance with the Rules of completing financial statements issued by the Ministry of Public Finances and in compliance with the National and International Rules of Audit (ISA 910). There rules require our audit to be planned and performed in order to obtain a reasonable assurance that there aren’t any significant distortion in annual accounts.

4. Except for the aspects included in paragraph 5, we performed the audit in compliance with the Audit Standards issued by the Romanian Chamber of Financial Auditors. These standards require the audit to be planned and performed in order to obtain a reasonable assurance that there aren’t any significant misstatements in the annual financial statements. The audit consists in examining, based on surveys, the justifying elements which support the amounts and information included in the financial statements. The audit also consists in evaluation of accounting principles and methods and of significant estimations made by Company’s management for the financial statements, and in their presentation. We consider that the performed audit offers a reasonable base for expressing our opinion.

5. We didn’t witness the stocks inventory at the end of the year, because, at that date, negotiations for prolongation the audit contract were not yet started, so that we weren’t able to acquire sufficient probing elements regarding the existence of the stocks at that date. The opening balance of the stocks represents a significant component of the cost of merchandise sold for the financial exercise. We weren’t able to quantify the possible impact of opening balance of stocks on the cost of merchandise sold for the financial exercise. The inventory was performed in compliance with the stipulations of OMFP no. 2861/2009.

6. Because the current assets are evaluated, as a general rule, in current prices, the stipulations of IAS 29 were not applicable.

Year N-1	Year N
7. Company Z SRL performed update of the account value for the following patrimony elements: external suppliers, cash in foreign currency, financial leasing and long-term loans in foreign currency. The entity didn’t perform reevaluation of fix assets in the year 2012. 8. The financial auditor observed that the entity has total debts in amount of 40.217.704 ron, out of which long-term debts of 16.926.388 ron, consisting of medium and long term bank loans in amount of 8.048.595 ron, financial leasing in amount of 3.005.508 ron, shareholders loans in amount of 2.010.691 ron and advances received in account of orders in amount of 3.861.594 ron; current debts in amount of 23.291.316 ron, out of which short-term bank loans in amount of 13.200.000 ron, commercial debts in amount of 9.037.617 ron and other debts in amount of 1.053.699 ron. 9. The financial auditor of the Company Z SRL mentions that, for the long term loans contracted with BRD, BCR, UniCredit Tiriac Bank and Banca Transilvania, the entity mortgaged and pledged plots of land, constructions and equipments, property of Z SRL, located in Sibiu, Cluj-Napoca, Alba Iulia, Deva, Aiud, Ocna Mures, Blaj, Mihalt, Santimbru and Barabant. 10. The audited company didn’t constitute provisions (temporary adjustments) for receivables registered at 31.12.2012. We mention that the entity didn’t register any receivables older than 180 days, therefore the provisioning is not justified. 11. In the financial exercise 2012 the equity value was not adjusted. 12. Also, to be mentioned that the audited entity registered operational profit in the financial exercise	7. Company Z SRL performed update of the account value for the following patrimony elements: financial leasing, cash in foreign currency and long-term loans in foreign currency. The entity perform reevaluation of fix assets from the group 2: “Constructions” in 2013. 8. The financial auditor observed that the entity has total debts in amount of 38.022.259 ron, out of which long-term debts of 17.238.411 ron, consisting of medium and long term bank loans in amount of 12.645.561 ron, financial leasing in amount of 2.781.813 ron, shareholders loans in amount of 1.811.037 ron; current debts in amount of 20.783.848 ron, out of which short-term bank loans in amount of 11.200.000 ron, commercial debts in amount of 6.133.889 ron, other debts in amount of 1.691.004 ron and advances received in account of orders, in amount of 1.758.955 ron. 9. The financial auditor of the Company Z SRL mentions that, for the long term loans contracted with BRD, BCR, UniCredit Tiriac Bank and Banca Transilvania, the entity mortgaged and pledged plots of land, constructions and equipments, property of Z SRL, located in Sibiu, Cluj-Napoca, Alba Iulia, Deva, Aiud, Ocna Mures, Blaj, Mihalt, Santimbru and Barabant. 10. The audited company didn’t constitute provisions (temporary adjustments) for receivables registered at 31.12.2013. We mention that the entity didn’t register any receivables older than 180 days, therefore the provisioning is not justified. 11. In the financial exercise 2013 the equity value was not adjusted. 12. Also, to be mentioned that the audited entity registered operational profit in the financial exercise 2013 in amount of 15.380.712 ron, loss from financial

2012 in amount of 9.944.001 ron, loss from financial activity in amount of 2.371.798 ron, gross profit in amount of 7.572.203 ron and a net profit in amount of 6.564.779 ron.	activity in amount of 2.798.562 ron, gross profit in amount of 12.582.150 ron and a net profit in amount of 10.872.038 ron.

13. The auditor notices that the entity presented us the journal registry and the inventory registry completed to date.
14. From analyzing the registry of Board of Directors protocols for the company Z SRL results that meetings of Board of Directors occur periodically and they are finished with synthesis of the decisions for each of the issues debated.
15. In our opinion, the financial statements show a fair image, under every significant aspect, of the financial position of the company Z SRL for the completed exercise, both in terms of patrimonial values and in terms of cash-flow, and also for the revenues, expenses and results, in compliance with OMFP 3055/2009 and with the International Financial Reporting Standards (IFRS).
16. The auditor's opinion on the financial statements for the completed exercise for the company Z SRL is an opinion without reserves, on the grounds that the future continuity of entity's activity is not endangered, because the entity has contracts in progress with various clients for the entire future year.
17. Without expressing reserves on the opinion, we draw attention to the following aspects:
17.1. The attached financial statements are not intended to present financial standing, result of transactions and complete set of notes to the financial statements, according to accountant regulations and principles accepted in countries and jurisdictions other than Romania. Therefore, the attached financial situations are not prepared for the use of individuals who don't have knowledge of the Romanian accountant and legal regulations
17.2. The standards, procedures and practices used in Romania for the audit of the financial statements may differ from the ones accepted in other countries and jurisdictions.
18. Given the financial situation of company Z SRL in the completed financial exercise, the auditor observed that the entity had no difficulty in participating to auctions, to insurance a portfolio of works according with the production capacity, therefore, in our opinion, the principle of future continuity of company's activity is not affected, because performance of works is expected, both in contracting and in sub-contracting.
19. This report is performed exclusively for the purpose of submitting financial statements for the company Z SRL, for the completed exercise, to the Ministry of Public Finances, for participating at auctions, for informing the management of Z SRL and also for other situations in which the company's partners require an audit report.

Signature,
Place, Date

Source: own synthesis and translation of C Auditor Report

4. Results and Discussion

As mentioned before, we examined audit reports issued by 3 different auditors, in order to observe the differences resulted from professional judgment in evaluating risks. Two of the auditors issued opinions without reserves and one of them issued a reserved opinion, but all of them concluded that the financial statements are fairly presenting, in all significant aspects, the financial position of the companies audited. There weren't any flagrant differences in the two periods examined, all auditors issued the same type of opinion when auditing the financial statements for the exercises 2012 and 2013. Differences occurred, naturally, in account balances, and also auditor A issued an opinion with fewer reserves for the financial exercise 2013, compared with 2012, which could mean that the management of company X assumed the reserves and observations issued for the previous year and took appropriate measures when performing internal control.

Regarding the evaluation of audit risk, we examined each of its components and made several deductions based on information provided by the audit reports:

We already established that the inherent risk and the control risk are belonging to the company, and the auditor has no control over them, he can only identify and evaluate them, in order to decide how much time will be dedicated to analyzing each account and class of transactions, in order to reduce the risk of un-detection to an acceptably low level so that the overall audit risk will be at an acceptably low level.

We don't have enough information in the audit reports to establish the level of *inherent risk* for any of the company audited. All the reports include a disclaimer, mentioning that the internal control is the responsibility of the company, without stating whether it was performed or not. Only auditor A includes in his opinion a reserve stating that the company X didn't organize an internal audit activity in the completed year, but doesn't say anything about internal control. As mentioned before, if the internal control was performed, the inherent risk does not exist, if any risk is identified, it will be a control risk. Assuming that it was not performed, we will consider, based on knowledge about the companies audited, other than information included in the audit reports, that there are reasons to consider that inherent risk exists only for company Y, which has over 90% dependency on one client. However, the inherent risk and control risk are evaluated together and, considering that for this company the auditor issued an audit opinion without reserves, there are only two possibilities: internal control was, in fact, performed or the auditor had enough probes not to consider the dependency on a client of company Y a factor of risk.

As regards the *control risk*, given that all reports claim that the audit reports obtained are sufficient and adequate, we can safely consider that control tests were performed, by examining the justifying documents, by observing the way internal control was performed and how it functions. Again, the opinions without reserves show that the combined level of inherent risk (if the case) and of control risk was evaluated as low, permitting, as we previously mentioned, an increased risk of un-detection, and still obtaining an acceptably low overall audit risk. In company A's case, the control risk is higher, as some mandatory adjustments weren't perform; most importantly, in the financial exercise 2012, old receivables weren't provisioned, and the provision should have diminish the result of the exercise. However, the value of the provisions is not significant, representing only 0,65% of the net exercise, which is ignorable.

We can only assume that all three auditors have evaluated the *un-detection risk* as low, as this risk is entirely in the responsibility of the auditor and he should do his best to diminish it, by planning correctly the audit procedures, by applying professional skepticism and by supervising and reviewing the audit process. Still, the un-detection risk may be high in case of company Z SRL, audited by auditor C, who didn't witness the inventory of stocks in neither of the two periods, and admits that these stocks represent a significant part of the cost of merchandise sold. The fact that the auditor issued opinions without reserves, may mean that the combined level of inherent and control risk was so low that it permitted this rather high un-detection risk.

5. Conclusions

Our intention, stated in the first chapter, was to fully understand, by definitions, examples and explanations, the audit risk and the relationship between its components. Certain assertions became obvious:

- inherent risk and control risk are connected and should be evaluated together, based on the auditor's professional judgment, depending on the quality of the management and of the control environment, on the nature of the activity, accounting policies and other factors detailed in this paper;
- inherent risk and control risk are outside auditor's control, the auditor being only able to evaluate them;
- un-detection risk, on the other hand, belongs to the auditor and is a measure of auditor's competence, occurring or increasing in case of using an inadequate audit procedure, in case of applying an adequate procedure in an inadequate way or incase of simply misinterpreting the audit results;
- professional judgment, an appropriate audit planning, a correct division of audit work, professional skepticism, supervising and reviewing the audit work become vital in issuing a correct audit opinion. In our case study, issuing a favorable opinion, without reserves, in the audit report issued by auditor C for the company Z doesn't prove professional skepticism at all, and the result would have been significantly different if any of the other two auditors should have audited the financial statements of company Z. It becomes recommendable for the companies, in order to minimize all audit risks, to periodically, once a several financial exercises, change the auditor company or, in case some warning signals exists, to organize more than one audit and compare the results. Because, unless fraud is the objective of the company's management and shareholders, a "flattering" audit report will never serve their interests, as it doesn't serve the interests of creditors, state, commercial partners, public etc.

6. References

[1] Danescu, T., „Internal control activities: Cause and effect of a good governance of accounting reportings and fiscal declarations", *Annales Universitatis Apulensis Series Oeconomica, 13(2),* Alba Iulia, 2011.
[2] Stoian, A.,"Financial and Accounting Audit", *Economica Publishing,* Bucuresti, 2001.
[3] Tiron Tudor, A., „The fundaments of the Financial Audit", *Accent Publishing,* Cluj-Napoca, 2009.
[3] *** „National Rules of Audit", *CECCAR Publishing,* Bucharest, 1999.
[4] *** „Auditing Handbook", *ACCA,* 1998/1999.
[5] *** The Body of Expert Accountants and Authorised Accountants in Romania (CECCAR), www.ceccar.ro
[6] *** The Romanian Chamber of Financial Auditors (CAFR), www.cafr.ro;
[7] *** The International Organisation of Supreme Audit Institution (INTOSAI), www.intosai.org/intosai-ov-9100-guidelines-for-internal-control- standards-for-the-public-sector.html
[8] *** The Committee of Sponsoring Organization of the Treadway Commission (COSO), http://www.coso.org/IC.htm
[9] Ojo, M., „Financial Regulation and Risk Management: addressing risk challenges in a changing financial environment", Munich Personal Repec Archive, Oxford, 2006.
[10] Moraru, M., Dumitru, F., „The Risk in the Audit Activity", Annals of the University of Petrosani Economics, 11 (3), 2011.
[11] Salomia, M.M., Pirnea, I.C., „Features on Risk Assessment in Financial Audit", Ovidius University Annals, Economic Sciences Series, vol. XIII, Issue 1, Constanta, 2013.

[12] Fearnley, S., Beattie, V., Brandt, R., „Auditor Independece and Audit Risk: A reconceptualization”, Journal of International Accounting Research, 39-71, 2005.

[13] Sahnoun, M.H., Mohamed, A., Z., „Effect of Auditee Business Risk, Audit Risk and Auditor Business Risk on Auditor/Auditee Negotiation Outcomes: An Experimental Study in Tunisian Context, Economic Research Forum, Working Paper Series, no. 467, 2009.