

Probe into the Auditing Solutions for Major Misstatement Risk

Lixia Wang & Cuicui Lian

School of Economics and Management, Changchun University of Science and Technology

Changchun 130022, China

E-mail: wlx0909@163.com

Abstract

Risk-oriented auditing is the trend of modern audit. In the new auditing principles' auditing risk model, auditing risks' core factor major misstatement risk includes the report mistake risk and the confirmation mistake risk. This paper discusses the methods for identifying and evaluating major misstatement risks, advancing an effective auditing procedure for decreasing major misstatement risks.

Keywords: Major misstatement risk, Identify, Evaluation, Auditing procedure

In recent years, many enterprises face serious financial cheat scandals inside and outside. The auditing failure case happens frequently. Auditors face unprecedented risk pressure. Meanwhile, enterprise operation's complexity and uncertainty further enhances the difficulty of auditing, making the auditing risk more prominent. How to response to this challenge has already become an urgent issue for Certificated Public Accountant (CPA). The auditing risk model regulated by auditing principles is: auditing risk = major misstatement risk * check risk. It regulates that evaluating major misstatement risk is the primary and necessary auditing procedure. To decrease major misstatement risks is the core to reduce auditing risks. A research on major misstatement risks seems to be more necessary and urgent.

1. An introduction to major misstatement risk

No.1101 Auditing Principles regulates: auditing risk is the possibility that there is major misstatement in financial reports and the CPA delivers improper auditing suggestions.

China Standard on Auditing No. 1101: Objective and General Principles Governing an Audit of Financial Statements points out: major misstatement risk refers to the possibility of major misstatement before auditing in financial reports.

Explain the two definitions: (1) The major misstatement risk is the initial risk before auditing in financial reports; (2) Misstatement (the sum or nature) is serious, which, independently or together with other misstatements can affect users' decisions. Otherwise, it is non-misstatement; (3) The major misstatement is only a possibility but not a fact; (4) The misstatement includes misstates or cheats concerning the sum in financial reports and appendix.

Major misstatement risk includes two kinds of risks concerning reports and confirmation:

(1) Major misstatement risks in reports usually connect with control environment, associating widely with financial reports. It is hard to focus on certain transaction, account surplus, and presentations.

(2) Major misstatement risks in confirmation concerns kinds of transactions, account surplus, and presentations. In accounting term, it is the major misstatement risk caused by confirming, calculating, and presenting the accounting factors.

2. Identify and evaluate major misstatement risk

"China CPA Auditing Principles No.1211 ----- Know audited enterprise and its environment and evaluate major misstatement risks" emphasizes that the CPA should know the audited enterprise and its environment, which can help to identify and evaluate the major misstatement risks in financial reports. In addition, this item explains how the CPA can know the audited enterprise and its environment and establish the auditing program.

2.1 Identify and evaluate the major misstatement risks in financial reports

For financial reports, the major misstatement risks associate closely with controlling environment, and also properly relate with the nature of audited enterprise (for example, the special industry) and the operation risks (such as the poor economic environment). Therefore, knowing the audited enterprise and environment, including the nature of the enterprise, the operation environment, operation risk, and internal control turn into the primary

conditions for evaluating risks.

The process of evaluating major misstatement risks includes mathematic model calculation, experimental judge, and subjective estimation. As auditors analyze and evaluate risks, they should start from knowing the audit environment, comprehensively analyzing and evaluating the factors causing major misstatement risks. Then, auditors probe into the financial reports. And finally, the key is to evaluate the major misstatement risks in confirmation.

(1) Identify and evaluate industrial risks

Know the industry where the audited enterprise lives widely, concerning the market supply and demand, competition, seasonal and cyclical production and operation, changes of production technologies, energy supply and cost, key industrial indexes, and statistical data. Identify the industrial risks of audited enterprise, such as the coals' price rising risk for thermal power plant. Or, the key technology for the audited enterprise is outdated in the industry. The audited industry is incapable of technological innovation. All these factors may make the CPA worry about the audited enterprise's continuous operation ability.

(2) Identify and evaluate the legal environment and supervision environment risks

Know the accounting principles, accounting system, and special industrial rules for the audited enterprise, laws and regulations affecting its operational activities, official policies influencing its business, concerning money, finance, taxation, and trade, and environmental requirements for the industry. For example, pollutant chemical enterprises, metal processing enterprises, and electric power enterprises should care the environmental risks. Food-processing industry should care food safety risk. For tobacco can wine industry with high taxes, it should care the tax-related risk.

(3) Identify and evaluate internal control risks

By researching on the enterprise's management rules, corporate regulations, the shareholders agreements, corporate development program, corporate salary manual, employees' position manual, the board conference records, audit committee records, the board resolution, and meeting records, auditors can know the audited enterprise's internal control environment, identifying the internally controlling risks.

2.2 Identify and evaluate major misstatement risks in confirmation

In confirmation, the major misstatement risks associate with certain special transactions, account surplus, and presentations. Focus on these risks as follow.

(1) Identify and evaluate the risk concerning accounting policy and taxation

Accounting principles and taxation rules are usually adjusted. Whether the enterprise does accounting based on new principles or not? For example, the Accounting Standard for Business Enterprises No. 33 ----- Consolidated Financial Statements, issued in 2006, adopts the theory of economic enterprise instead of the theory of mother-company. The Accounting Standard Interpretation for Business Enterprises No.1 (The Interpretation No.1 for short) further perfects the law of equity: for the internal transactions between investment enterprise, joint enterprise, and associated enterprise, the interests, belonging to investment enterprise, calculated by the proportion of shares, should be canceled. Then, establish the interests or the loss of investment. If an internal transaction happens between the audited enterprise and joint enterprise or associated enterprise, there is maybe major misstatement risk in the confirmation of long- term equity investment account.

For another example, according to regulations in Accounting Standard for Business Enterprises No. 9 ----- Employee Compensation: If an enterprise cancels the labor relationship with any employee prior to the expiration of the relevant labor contract or brings forward any compensation proposal for the purpose of encouraging the employee to accept a layoff, and the following conditions are met concurrently, the enterprise shall recognize the expected liabilities incurred due to the compensation for the cancellation of the labor relationship with the employee, and shall simultaneously record them into the profit or loss for the current period. Where the enterprise has formulated a formal plan on the cancellation of labor relationship or has brought forward a proposal on voluntary layoff and will execute it soon. This plan or proposal shall include the department at which the employee to be laid off works, the post of the employee and the number of the employees to be laid off, the amount of compensation for the cancellation of labor relationship or for layoff as determined on the basis of the job category or post according to the relevant provisions, and the planned time for the cancellation of labor relationship or layoff. The enterprise is unable to unilaterally withdraw the plan on the cancellation of labor relationship or the layoff proposal. The early-retired employees can get wages by referencing to the welfare of layoff. If there are early-retired employees in the audited enterprise, there may be

major misstatement risk in the confirmation of wage account.

(2) Identify and evaluate the risk of accounting information disclosure

Listed companies should disclose the real and sufficient information that may affect investors' decision fairly in time. That is an obligation for them. In a macro aspect, it can benefit the national macro adjustment and control, the operation of market, the optimal distribution of social resources, and the securities market order, driving the development of securities market. In a micro aspect, viewing from the information demander outside the enterprise, it can protect the interests of information users, such as investors and creditors. Therefore, the CPA should focus on the information disclosure of audited enterprise, identifying the risk of accounting information disclosure. For example, the audited enterprise may plan an important investment but the financial statements do not disclose. Or, if the audited enterprise performs more related transactions, there is major misstatement risk in the confirmation of disclosure of related transactions.

3. Adopt proper auditing procedure and reduce major misstatement risk

The CPA establishes a general solution based on financial reports' major misstatement risks. Under its guidance, make up and apply a further audit procedure focusing on major misstatement risk in confirmation. The general solution directly affects the audit of many confirmations. The general solution includes essential solution and comprehensive solution. The former means the CPA will take essential procedures as the main body. The later means the CPA will adopt the control test and the essential procedures at the same time.

Compared with the confirmation, the CPA merely focuses on the major misstatement risk in evaluated financial reports by using the risk model. It will emphasize on taking an overall solution, considering the great impact of general solution. The major misstatement risks in overall financial reports can influence many confirmations. Only when apply the risk model to the two levels, combining the two together, can it reduce the audit risk to an acceptable level. If the CPA can not evaluate the major misstatement risks in financial reports rightly or wrongly estimate the general solution, it will cause a wide decisive unfavorable result. Therefore, we should emphasize on the application of new risk model in financial reports.

The CPA can adopt these specific control test procedures as follow:

(1) Observation and inquiry

Before the auditing, the CPA can know conditions of the audited enterprise by the website of China Securities Regulatory Commission, the local website of audited enterprise, and other news media, learning the market competition, production pricing, and industrial regulation of the industry that the audited enterprise operates by Internet.

After the start of auditing, the CPA can observe the audited enterprise's production organization, operation environment, personnel, environment-protection facilities, and employees' work attitudes. Visit the production shop. Know the production flow and consult related employees. By this way, the CPA can establish the key point in auditing.

(2) Interview

The CPA can make up a detailed interview plan according to the evaluated major misstatement risks. Interviewing the related people can help to make the re-evaluation on major misstatement risks. For example, a chemical enterprise produces new products. If the pollutant issued in production exceeds the permitted standard, the CPA may worry about the audited enterprise's continuous production ability. For this issue, the CPA can interview with vice production present, production manager, the responsible officer for environment protection, and front workers. By means of interviews, the CPA can get more proofs to prove that the enterprise gets new pollutant issue permission or adopts practical and effective emission reduction measures in order to reduce the major misstatement risks to an acceptable degree for the CPA.

(3) Discussion

The auditing team, as a collectivity, exerts an extremely important effect on the practice of CPA. The auditing team should discuss the major misstatement risks one by one, and research on the measures reducing major misstatement risks.

(4) Check all meeting records

Shareholders meeting records, the board meeting record and the auditing commission records are important for the audited enterprise. By examining these meeting records, the CPA can master the guidance and strategy of audited enterprise.

(5) Get external proofs

External proofs are the most direct and powerful auditing proofs. But it is hard to get them and cost a lot. If a major misstatement item can not be reduced to an acceptable level by internal proofs and applying relevant auditing procedures, we must get external proofs. If the CPA finds a major misstatement risk in the confirmation of related transaction between audited enterprise and associated parties, and the CPA can not allow the existence of possibility of major misstatement risk, by interviewing some people, examining the board meeting records and shareholders meeting records, the CPA can get the official documents concerning the audited enterprise from the Administration for Industry and Commerce, reducing the major misstatement risk by obtaining external proofs.

(6) Apply an internal control test based on business cycle

If the CPA determines to believe the audited enterprise's internal control, it is necessary to execute a control test. The aim is to test the effectiveness of internal control defending, identifying, and correcting the major misstatement risks in confirmation. Then, evaluate the major misstatement risks in confirmation. As the CPA agrees that the risk identified by the risk evaluation program is serious, or the essential procedures can not offer sufficient and proper auditing proofs for the confirmation, the CPA should apply the control test on this kind of risks. Meanwhile, the new principles emphasize that the CPA should hold a professional doubted attitude. Even if the major misstatement risk is at a lower level, which merely proves that the expected internal control is good, it is necessary to perform the control test, which can support the evaluation. Therefore, in many conditions, the CPA will perform the control test.

By examining the circulation of financing and investment, the circulation of purchase and payment, the circulation of production and stock, the circulation of sale and return, the circulation of wages and personnel, and the circulation of fixed assets, the CPA can evaluate whether the audited enterprise's internal control is effective or not. If the internal control is effective, the formerly-evaluated major misstatement risks are at a lower level. If the internal control is ineffective at certain ring, it is necessary to extend the essential procedures for relevant accounts.

Whether the internal control is effective or not, it is necessary to perform an essential test on kinds of key transactions, account surplus, and presentation. The CPA can check the major misstatement risks at the confirmation level by essential tests, find serious misstatements at this level, and reduce the risks at the acceptable level. According to the requirements of auditing risk model based on major misstatement risks, the CPA can establish the acceptable risk level by taking the evaluation of major misstatement risks as the base, and taking possible auditing risk level into consideration. Then, plan and apply the essential program. With pre-determined auditing risk level, there is a reverse relation between the acceptable check risk level and the evaluation result of major misstatement risk in confirmation. The check risk is determined by the effectiveness of essential test design and execution. The CPA should reasonably design the essential test's nature, time, and scope and make it effective in practice, reducing the check risk to an acceptable level.

References

- Han, Yanhua. (2007). Auditing risks and precaution. *Group Economics Research*, No. 1.
- Wang, Chengyong. (2009). On auditing response to material misstatement risks. *Friends of Accounting*, No. 9.
- Xin, Jiatong. (2007). Studies on material misstatement risks under new principles. *Commercial Culture*, No. 6.