

EVOLUTION OF THE METHODOLOGICAL PROVISION OF RISK-BASED AUDIT APPROACH

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Abstract - The article is devoted to the study of the evolution of the audit methodological provision. Extensive historical phases of evolution of the audit approaches have been considered. Basics of risk-based audit has been uncovered. as an effective tool of state financial control in public administration from a historical perspective. Domains of the theory and practice of audit on methodological level have been researched and propose. Prospects for further development of methodological support of state financial audit using risk-oriented audit based on data in the conditions of informatization are revealed.

Keywords - Risk-Oriented Audit, Audit Methodology, Digital Transformation.

I. INTRODUCTION

In the papers on the economy of familiar authors, different approaches to the periodization of the development of audit types are distinguished [1]. In this matter, the authors distinguish conceptual, evolutionary, and methodological periodization, which contributes to the development of audit as a scientifically based independent field of economic science. Throughout its extensive history, the methodological underpinnings of auditing have undergone a profound evolution, encompassing three distinct developmental epochs:

The Confirmatory Audit Phase - Late 19th to Early 20th Century (1930s):

This phase, rooted in the "Adequacy Theory," finds its origins in the pioneering works of English theorists such as F. Pixley and L. Dixie. Operating under the tenets of this theory, auditors employed a direct and sequential approach, seeking to attain confirmation through a direct comparison of financial statements with data generated within the accounting system. The primary objective of adherents to this theory was the identification of both voluntary and involuntary errors that might have infiltrated the audited reports.

In this context, the audit's role was to scrutinize the actual occurrence of past events, ascertain their accuracy, and provide answers to the fundamental question of the factual unfolding of events [1]. Auditors, in this era, predominantly focused on the validation of documentation substantiating the flow of cash transactions, as well as the correct categorization of these transactions within financial statements. The collection of audit evidence hinged on accounting registers and associated documents.

The emergence and application of the adequacy theory in practical auditing signified the inaugural phase in the development of auditing theories, commonly referred to as the "confirmatory audit" period.

Notably, scholars have identified certain drawbacks inherent in this theory. For instance, G.A. Yudin and M.N. Chernykh remarked, "A limitation of this approach is that the auditor fails to consider the interrelation of indicators presented in financial (accounting) records with the overall financial and economic activities of the audited entity. When conducting such audit procedures, the auditor relies solely on information furnished by the accounting department and interfaces exclusively with accounting personnel". Another noted limitation of this theory is that "by the time a potential investor becomes acquainted with the auditor's opinion, that opinion may already be outdated".

The System-Oriented Audit Phase - 1940 to 1980:

The "system-oriented audit" era evolved from the underpinnings of the "controlling" theory. This phase surmised that if the internal control system functioned effectively, there was no imperative need for detailed scrutiny, as auditors could place their trust in the internal control system to detect errors and breaches of legal requirements [1]. In the presence of a robust internal control system, the likelihood of errors was deemed minimal, and financial reports were considered sufficiently comprehensive and accurate.

Nevertheless, scholars have identified shortcomings inherent in this theory and the corresponding audit approach. A notable limitation lies in the fact that audit procedures primarily revolved around assessing the organization and efficacy of the internal control system, which predominantly centered on examining the actions of the personnel within the audited economic entity. However, the conduct of the management (administration) was not subjected to such scrutiny. Consequently, audit procedures within this paradigm primarily focused on uncovering potential deception by staff toward management rather than evaluating the management's interactions with investors. Moreover, this approach was found to diminish the objectivity of reported data [2].

The Era of Risk-Based Audit - Late 20th to Early 21st Century:

R. Dodge provides a retrospective exploration of the evolution of audit methodologies. He discerns distinct stages and underscores the necessity to transcend theoretical frameworks, emphasizing a shift towards practical business concerns. Dodge notes, "The system-oriented approach to audit enabled us to observe the systems governing operations. In risk-based auditing, our focus turns to the individuals overseeing these systems". R. Adams, in his interpretation of the risk-based audit approach, characterized it as probabilistic, positioning it as a contemporary companion to the system-oriented model. Importantly, Adams places heightened significance on audit evidence derived not only from the examination of internal control systems but also from analytical procedures and assessments of the impact of internal risk factors within the client's sphere. American scholar J. Robertson, who defines audit as "an activity aimed at reducing business risk," offers a succinct conceptualization: "Audit is the process of mitigating information risk to an acceptable level for users of financial reports".

At its core, this approach to audit aligns with the consulting theory, closely intertwined with enterprise efficiency. Consulting theory diverges from the examination of mere documents, delving into the underlying realities beyond registered economic activities, with a forward-looking orientation. On this foundation, the "risk-based auditing" methodology has emerged.

In the practice of auditing or consulting, firms prioritize the calculation of potential risks. The audit of a client's business is conducted through the lens of various factors, encompassing the control environment, potential pressures on management to manipulate income figures, affiliations, the client's standing within its industry, and the broader economic context in which it operates [2]. This form of audit derives from the unique circumstances of the client's business and deploys selective audit techniques, primarily focusing efforts where the risk of fraud and errors is most pronounced [2].

It is imperative to acknowledge that contemporary methodological approaches to auditing are firmly rooted in principles promulgated by the Commission for Combating Unreliable Financial Reporting, often referred to as the Treadway Commission. This commission advanced an integrated concept of internal control encapsulated in the COSO model, which prescribes that auditors assess the efficacy of internal control systems based on its components [3]. The COSO (Committee of Sponsoring Organizations of the Treadway Commission) model, also known as the COSO framework, is a widely recognized and respected framework for enterprise risk management and internal control. It provides a structured approach to assessing and managing risks within an organization. While it wasn't specifically designed for

auditing, it serves as a valuable foundation for risk-oriented audit processes. Here is an overview of the key components of the COSO model as they relate to risk-oriented auditing:

Control Environment:

Description: This is the foundation of the COSO framework. It sets the tone for the entire organization regarding internal control and risk management.

Relevance for Auditing: In a risk-oriented audit, auditors assess the organization's control environment. They evaluate the commitment of management to ethical values, the competence of personnel, and the organization's structure. An effective control environment is essential for managing risks and maintaining proper internal controls.

Risk Assessment:

Description: This involves the identification, assessment, and prioritization of risks that could impact the achievement of organizational objectives.

Relevance for Auditing: Risk-oriented audits focus on understanding the organization's risk assessment processes. Auditors assess how well risks are identified, evaluated, and prioritized. They also examine whether the organization has mechanisms in place to respond to identified risks.

Control Activities:

Description: Control activities are the policies and procedures established to address identified risks and ensure that management directives are carried out.

Relevance for Auditing: Auditors examine the control activities in place. They assess whether these controls are designed effectively to mitigate risks and whether they are being consistently applied. Any weaknesses or gaps in control activities are noted for remediation.

Information and Communication:

Description: Effective communication of information is essential for making informed decisions about risk management and internal control.

Relevance for Auditing: Auditors evaluate how information flows within the organization, including whether there is clear communication of roles, responsibilities, and risk-related information. They also assess whether information is timely and accurate.

Monitoring Activities:

Description: Monitoring activities involve ongoing assessments of the internal control system's effectiveness.

Relevance for Auditing: Auditors review the organization's monitoring activities to ensure that they are designed to detect control deficiencies and changes in risk. They assess whether monitoring is conducted regularly and whether corrective actions are taken when deficiencies are identified.

The COSO model provides a structured framework that auditors can use to assess the effectiveness of an organization's internal controls and risk management processes. In a risk-oriented audit, auditors focus on these key components to determine whether the organization is adequately identifying, assessing, and mitigating risks that could impact its objectives [3]. By following the COSO model, auditors can help organizations strengthen their risk management and internal control processes, ultimately enhancing the organization's ability to achieve its goals while managing risks effectively.

II. FUNDAMENTALS OF RISK-ORIENTED AUDIT

The risk-based audit methodology is a framework shaped by the International Standards on Auditing (ISAs). When conducting an audit in accordance with ISAs, an auditor is tasked with acquiring reasonable assurance regarding the overall accuracy of financial statements, ensuring they are devoid of material misstatements. The auditor's reasonable assurance hinges upon the meticulous accumulation of audit evidence, a process essential for rendering an opinion on whether the financial statements have been prepared in adherence to the applicable financial reporting framework. However, it is imperative to acknowledge that inherent limitations exist, impacting the auditor's capacity to detect material misstatements, rendering absolute assurance unattainable.

These limitations are associated with the following factors:

Random Testing Utilization: Auditors rely on the deployment of random checks, or testing, as part of their audit procedures.

Constraints Inherent in Accounting and Internal Control Systems: These constraints encompass elements such as collusion, misuse, and fraudulent activities within the systems.

Persuasive, Not Exhaustive, Audit Evidence: The bulk of the evidence collected during the audit process is persuasive rather than exhaustive in nature.

Additionally, the formation of the auditor's opinion entails the exercise of professional judgment concerning the collection of audit evidence, encompassing aspects like the timing, nature, and extent of audit procedures. Consequently, it is imperative to comprehend that the auditor does not assert that the financial statements are entirely devoid of material misstatement, as the acquisition of absolute assurance remains elusive. Furthermore, the auditor's opinion neither guarantees the future viability of the organization nor assesses the effectiveness of the management's stewardship of the organization.

The primary objective of the auditor when conducting a risk-based audit is to secure reasonable assurance regarding the absence of material misstatement in the

financial statements, whether arising from fraud or errors. This task involves three core steps:

Assessment of Risks of Material Misstatement in Financial Statements: The auditor initiates the process by evaluating the risks associated with material misstatements in the financial statements.

Development and Implementation of Audit Procedures: Subsequently, the auditor formulates and executes audit procedures designed to mitigate the identified risks of misstatement.

Issuance of Auditor's Report: Based on the results of the audit, the auditor finalizes the process by issuing an auditor's report.

The concept of reasonable assurance inherently acknowledges the existence of a risk pertaining to an inappropriate audit opinion. This risk, which revolves around the possibility of the auditor expressing an erroneous audit opinion when material misstatements are present in the financial statements, is termed "audit risk."

The International Standard on Auditing (ISA) formally recognizes the risk of material misstatement (RMI) as an integral element within the broader concept of audit risk (AR). This risk of material misstatement is further delineated into two fundamental components:

Inherent Risk (IR): This denotes the inherent risk intrinsic to any operational activity or business process.

Control Risk (RC): Control risk represents the risk associated with the inefficiency or ineffectiveness of the internal control system.

Consequently, the risk of material misstatement can be articulated through the following formula:

$$Risk_{\text{Material-misstatement}} = Risk_{\text{inherent}} \times Risk_{\text{control}}$$

Both inherent risk and control risk pertain to risks inherent within the audited entity, existing independently of the financial statement audit. The auditor's evaluation of the risk of material misstatement, particularly at the assertion level, forms the foundational basis for subsequent audit procedures.

An additional facet of audit risk is detection risk (NR), which embodies the risk that the auditor may fail to uncover misstatements during the audit process. The extent of this risk of non-detection hinges upon the efficacy of audit procedures and the professional competence of the auditor. It is crucial to acknowledge that the risk of non-detection cannot be completely eradicated. This stems from the auditor's typical practice of not conducting exhaustive examinations. Rather, the choice of an inappropriate audit procedure or the misinterpretation of audit findings can heighten the risk of non-detection.

As a result, we can derive the subsequent formula for audit risk:

$$Risk_{\text{audit}} = Risk_{\text{not-detected}} * Risk_{\text{inherent}} * Risk_{\text{control}}$$

Within the framework of the risk-based audit concept, the reduction of audit risk to a level deemed acceptably low necessitates a meticulous evaluation of the risks of material misstatement and a concurrent limitation of the risk of non-detection. To achieve this, the auditor is tasked with comprehending the organization's operations, assessing the attendant risks, and executing audit procedures encompassing the following key areas:

Potential Inaccuracies, Errors, or Omissions in Financial Statements: The auditor must scrutinize financial statements for possible inaccuracies, errors, or information omissions.

Potential Evasion of Controls and Financial Statement Manipulation by Management: The auditor should remain vigilant to the potential circumvention of controls and the manipulation of financial statements by the management.

Effectiveness of Internal Controls: The effectiveness of internal controls, including their design and implementation, warrants meticulous evaluation.

The task of limiting the risk of non-detection can only be achieved through the enhancement of audit procedures, continual monitoring of the quality of audit assignments, and the elevation of the auditor's professional proficiency.

III. RISK-ORIENTED AUDIT IN DIGITAL TRANSFORMATION ERA

In the age of digital transformation, where organizations are rapidly embracing technology to gain a competitive edge, the landscape of auditing is undergoing a profound revolution. Traditional audit methodologies are being reshaped to accommodate the dynamic and complex digital environment [4]. One of the most significant adaptations is the shift towards risk-oriented audit methodologies. This essay explores how the methodology of risk-oriented audit has evolved in response to the challenges and opportunities presented by the digital transformation era. We have researched and found the following domains of changes that would definitely impact the theory and practice of audit on methodological level:

The Digital Transformation Landscape:

The digital transformation era is characterized by the pervasive adoption of advanced technologies such as artificial intelligence, big data analytics, cloud computing, and the Internet of Things (IoT). These technologies have not only transformed how organizations operate but have also introduced new types of risks and opportunities [5].

The Traditional Audit Approach:

Traditional audit methodologies often followed a checklist-based, compliance-focused approach. Auditors primarily examined financial records, internal controls, and compliance with regulatory requirements. While this approach remains essential, it struggled to keep pace with the digital revolution.

The Emergence of Risk-Oriented Audit:

The digital transformation underscored the need for a more proactive and adaptable audit methodology. Risk-oriented audit emerged as the answer. This approach focuses on identifying and assessing risks that are unique to the digital landscape, such as cybersecurity threats, data privacy concerns, and technology-related operational risks.

Key Evolutions in Risk-Oriented Audit Methodology:

a. Emphasis on Data Analytics:

With vast amounts of data generated by digital systems, auditors now harness data analytics tools and techniques to identify anomalies, trends, and potential risks. This data-driven approach allows for more precise risk assessments.

b. Cybersecurity Auditing:

As cyber threats proliferate, risk-oriented audit methodologies incorporate comprehensive cybersecurity audits. Auditors assess an organization's ability to protect sensitive data and respond to cyber incidents effectively.

c. Continuous Monitoring:

Digital transformation has led to the expectation of real-time insights. Auditors are shifting towards continuous monitoring, allowing them to identify risks as they emerge and promptly address issues.

d. Adaptation to Agile and DevOps:

With the adoption of agile methodologies and DevOps practices in software development, auditors are modifying their approach to ensure that controls and compliance considerations are integrated seamlessly into these processes.

e. Third-Party Risk Management:

The digital era often involves extensive reliance on third-party vendors and cloud service providers. Auditors now place a heightened focus on assessing the risks associated with these external relationships.

f. Ethical and Responsible Tech Auditing:

In an era of increased scrutiny on ethical and responsible tech use, audit methodologies incorporate assessments of an organization's ethical and societal impacts, aligning with stakeholders' expectations.

Numerous scholars attribute the genesis of the risk-oriented phase of auditing to its alignment with the principles of consulting theory [3]. In this context, the objectives of a consulting-oriented audit are intertwined with assessing the risk associated with financial statement misrepresentation and uncovering latent operational potential. This signifies a shift from the traditional financial statement-centric audit to a comprehensive business-focused examination. Noteworthy characteristics encompass the application of a risk-centered approach and the provision of an extensive array of audit-related and ancillary services within the auditing domain. The utilization of a risk-based audit methodology entails a concentration of efforts on areas harboring elevated potential risks. This approach also involves an evaluation of the competencies of individuals overseeing the system and the strategic decisions they enact. Moreover, it is

geared towards fostering optimal synergy between internal and external auditing functions. Essentially, risk-based auditing amalgamates the advantages inherent in both confirmatory and systems-oriented audit methodologies. It is distinguished by its inclination to extensively employ audit sampling techniques, especially concerning pivotal junctures or critical points.

IV. CONCLUSION

The digital transformation has necessitated a fundamental reimagining of audit methodologies. Risk-oriented audit, with its adaptability, data-driven insights, and focus on emerging digital risks, has become paramount. Auditors now play a critical role in helping organizations navigate the complexities of the digital era while safeguarding against the ever-evolving landscape of risks. As technology continues to advance, risk-oriented audit methodologies will evolve in tandem, ensuring that audits remain relevant, effective, and forward-looking in the digital age.

It is imperative to acknowledge the introduction of a qualitatively novel approach to evaluating audit risks. Historically, auditors predominantly concentrated on the risk of material misstatement within financial statements. Contemporary audit practices pivot towards scrutinizing business risks that wield a direct impact on the assessment of an entity's going concern assumption.

It is pertinent to highlight that in contemporary conditions, all three auditing methodologies find utility to varying degrees, particularly within organizations subject to obligatory audit mandates. Each of these auditing theories carries its distinct advantages and drawbacks. An excessively rigid adherence to any one theory constricts the scope of inquiry and impedes the attainment of a comprehensive and objective overview. However, this limitation can be surmounted by judiciously integrating insights from each theory.

Simultaneously, the ongoing evolution of auditing is intrinsically intertwined with its intersection with

other disciplines, including risk management, strategic management, tax management, investment analysis, and investment design. This convergence compels auditors to transcend the confines of their profession and necessitates the adoption of an interdisciplinary approach.

Consequently, the contemporary landscape witnesses the evolution of both the theory and practice of auditing. Within this milieu, particular emphasis is placed on the maturation of risk-based auditing. This methodology directs its focus towards areas characterized by heightened potential risks. It entails the evaluation of the competencies of those overseeing the system and the strategic judgments they make. Risk-based audit can be synergistically executed in conjunction with confirmatory and systems-oriented auditing methodologies, harnessing the strengths of each. It underscores the extensive deployment of audit sampling techniques, particularly in the examination of critical operational junctures. Moreover, it steers its scrutiny towards business risks that exert a substantial influence on the ongoing viability of an economic entity. In sum, risk-based auditing is instrumental in offering a judicious assessment of an entity's financial robustness, risk landscape, and the uncertainties that may impact future development.

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