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A Model to Reduce Internal Auditing Risk in SMEs

KEYWORDS: auditing risk, auditing process, small and medium enterprises, stakeholders.

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ABSTRACT *The financial statement may not contain correct or truthful information and, as a consequence, stakeholders' interests may be damaged. To avoid such risk, legislators have established certain obligations concerning the auditing of disclosures.*

The paper has a double objective. Firstly, the audit risk approach used by the auditors within a specific small and medium enterprise (SME) is analysed. Secondly, a theoretical model of the limitations of typical risks involved in the SME auditing process is created.

According to the audit risk approach, audit risk can be seen as the union of different risk categories, which can be more or less directly influenced by the conduct of the auditor. Such risk components influence each other. Every risk component can be more or less influenced by the small size of a SME.

A model for the reduction of audit risk in an SME depends on the typical factors of an SME and the attentive and efficient planning of the audit activity.

1. Introduction

As part of their relationship with stakeholders, companies provide continuous information aimed to make their economic and financial dynamics clear from a past and future perspective (Ferrero, Dezzani, Pisoni & Puddu, 2001; Giacosa, 2012). The communication process can be considered as a form of "lubricant" for the connection mechanisms between a company and its stakeholders (Bianchi, 1997; Corvi, 1997).

The financial statement is the main document by which to convey this information, thanks to which the company communicates its business trends to external parties (Giovando, 2012), permitting to observe these trends *through the management's eyes* (Hunt, 1996). The financial statement reflects the voluntariness of the corporate governance with regards to the entity and the distinctive traits of the interactions between the company and its *stakeholders* (Pini, 1995), and can also contain voluntary disclosure according to management's discretion.

In order for the financial statement to correctly and truthfully represent the company's economic and financial situation, every company must possess a control system aimed at reducing all risks affecting the business's management and compromising the objectives pursued by the company (Ferrero 1968; Airoldi, Brunetti & Coda, 2005). Among these risks is the possibility of the financial statement not containing correct or truthful information, and, as a consequence, the possibility that stakeholders' interests may be damaged. To avoid such risk, legislators have established certain obligations concerning the auditing of disclosures, so that the economic and financial communications derived from the financial statement are ensured to be reliable and the expectations of the company's stakeholders are upheld.

The paper has a double objective. Firstly, the *audit risk approach* used by the auditors within a specific small and medium enterprise (SME) is analysed. Secondly, a *theoretical model of the limitations of typical risks involved in the SME auditing process* is created; these risks are represented by the possibility that the opinions expressed by the auditor are inconsistent with the inferences from the financial statement.

Within the delineation of the audit risk approach, and in the creation of the above- theoretical model, we assumed that the auditor is not completely autonomous in deciding how to limit risks. Indeed, he must respect the European community legislation aimed at unifying and harmonizing in the different member states the obligations concerning auditing in the financial statement. Hence, there was a necessity to refer to auditing normative.

This paper is articulated in the following way. After a brief analysis of the legislation and the literature related to auditing in SMEs, a description of the research methodology is provided for the purpose of illustrating the various phases of the research. Next, the findings are presented, and finally, some closing considerations are given before contextualizing the research's implications and limitations.

2. Literature

Economic and financial communication acts as a connection between the company and its interlocutors (Di Stefano, 1990; Behn, Carcello, Hermanson & Hermanson, 1997), and thus becomes a constant management tool (Coda, 1989) derived from the faith placed by stakeholders in the company's inclinations to meet their expectations (Mitchell, Agle & Wood, 1997; Frooman, 1999). This communication process is intended to create and improve harmonious connections among the different members of the company and the external context (Dahnke & Clatterbuck, 1990).

With particular reference to the information produced by internal auditing, it favours the evaluation of the activities trend by the stakeholders, and aims to assure the quality (Power, 1999; Dunn and Mayhew, 2004) and the accuracy (Mautz & Sharaf, 1997) of disclosures of the company. As a consequence, the role played by the auditor contributes to solving the set of problems typical of Agency Theory (Alchiam & Demsetz, 1972; Jensen & Meckling, 1976; Fama, 1980; Rasmusen, 1987) that exist between the stakeholders and management (Watts & Zimmerman, 1983, 1986).

In addition, the auditor's function is to improve the company's image (Cameran, Moizer & Pettinicchio, 2010), which forms a sort of marketing and customer retention function (Gummesson, 1979; Hackenbrack & Hogan, 2005; Hodges & Young, 2009; Clow, Stevens, McConkey & Loudon, 2009). The more experience the auditor is perceived as having, the more noticeably a company's image may be improved (O'Donohoe, Diamantopoulos & Petersen, 1991; Broberg, Umans & Gerlofstig, 2013).

The information produced by the auditor also has the function of guaranteeing a transparent comparison (Dezzani, Pisoni & Puddu, 1995) with other possible forms of investment, either within the same company or across different ones, thereby limiting information asymmetries (Stigler, 1994) and the inefficiency of the markets (Fama, 1970; Cornell & Roll, 1981; Fama, 1995; Vaciago & Verga, 1995). While, on the one hand, this information asymmetry leads to the abovementioned market inefficiency, on the other, it incentivizes the increase of collective forms of control and observation (Galbraith, 1967): this is due to a self-generating force that comes to life in the market in order to control the company power.

The audit activity is also aimed to protect the bearers of risk capital, as well as other categories of stakeholders (Leftwich, 1980; Watts & Zimmerman, 1986; Mautz & Sharaf, 1997; Collier, 2008). Naturally, the more a company's flexibility grows, the more the audit risk increases (Marden & Brackney, 2009), while industry expertise may improve the efficiency of audit judgements (Moroney, 2007).

The literature includes a series of studies in which the stakeholders are assigned to different categories, thereby comparing the needs of SMEs with those of big companies (Van Peursem & Jiang, 2008). In order to protect the interlocutors, the legislation related to internal auditing also differentiates the company's obligations from the perspective of stakeholder protection in SMEs (Dang, Marriott & Marriott, 2006; Müllerová, Paseková, Strouhal, Deaconu, Knapová & Dvoř áková, 2011).

As any economic and financial information, the auditing disclosures produced by the company is either mandatory or voluntary by nature. With reference to mandatory legislation (Quagli & Teodori, 2005) concerning companies' auditing, several studies have been conducted on the European Community Directive 2006/43/CEE, which focuses on internal auditing (Mullerova, Pasekova & Strouhal, 2011). Researchers have analysed the harmonizing politics of the normative concerning the internal auditing, and how this is applied to the companies in the various member states (Doupnik & Salter, 1993; Hung & Subramanyam, 2007; Bode, 2007). International Standards on Auditing (ISAs) have been elaborated and issued by the International Auditing and Assurance Standards Board, and were recently completely revised and rearranged in terms of their structure and content and called as "Clarified ISAs" to apply to financial statements from 2010 onwards.

The clarified ISAs represent actual dispositions which count as law, and take precedence over the accounting standards issued by the accountancy organizations operating in the various states in the preparation of financial statements. These latter, in fact, dictate the guidelines for the preparation of financial statements, and do not represent a disposition which counts as law, but rather merely an interpretation of the legislation (Bava & Devalle, 2011). In addition to ISA 450, which represents absolute innovation within the auditing system, there are six other principles: on one hand ISA 210, which is concerned with evaluation of the acceptance of the auditing task; and on the other, ISA 700, 705, 706, 710 and 720, concerning the development and content within the financial statement. On the whole, following the "Clarity Project" effective between 2004 and 2009, 36 ISA principles have been validated, among which 20 documents have been redrafted and 16 revised.

Voluntary information (Collis, 2010) in the field of auditing has a beneficial effect on the market: it improves the confidence shown by financial analysts and investors towards the company, and potentially increases the positive impact on share performance (Blacconiere & Patton, 1994; Gigler & Hemmer, 2001). Some studies (Bava, 2011) have in fact observed that the clarified ISAs possess a very precise structure, composed of both mandatory and voluntary elements.

The ISAs sometimes contain a specific discipline for their implementation to smaller companies, since internal auditing within these also has to be carried out in compliance with the clarified ISAs. Nevertheless, the discipline has to evaluate the different contexts, dimensions and complexities of the specific company under examination.

In order to implement internal auditing within SMEs, a series of more practical documents have been issued. Among these is the guide set forth by the International Federation of Accountants (IFAC), which is the primary global organization for the accounting professions. This guide represents a practical contribution towards implementing internal auditing in smaller companies. Although it does not represent a new principle, it does constitute a useful tool by which to understand and apply the clarified ISAs to SMEs.

3. Research methodology
The research was conducted on several levels:

a) The theoretical one: the theoretical perspective sought to enable the analysis of the existing normative literature on auditing an SME. Knowledge of the related legislation, such as via the studies concerning it, can serve as a starting point in the creation of a model on the reduction of audit risk, particularly since the auditor is not completely autonomous in carrying out his activity, but, on the contrary, must respect the relevant legislation.
b) A theoretical one: a theoretical model was then built to demonstrate how to limit SME audit risk. Audit risk hinges on the possibility that the judgement expressed by the auditor may be inconsistent with what is inferable from the financial statement.

In order to meet the research objectives, the study focuses on the following core research questions:

-RQ1: How is the audit risk approach dealt with in SMEs?

-RQ2: How can the audit risk within SMEs be reduced according to the audit risk approach?

On the basis of these research questions, the following hypotheses have been developed:

a) *H1*: According to the audit risk approach, audit risk can be seen as the union of different risk categories, which can be more or less directly influenced by the conduct (activity) of the auditor. Such risk components influence each other. H1 is paired with RQ1.
b) *H2:* A model for the reduction of audit risk in an SME depends on the typical factors of an SME and the attentive and efficient planning of the audit activity. H2 is paired with RQ2.

The research method is organized into the following phases:
a) **Phase 1**: this concerns an analysis of auditing regulations and literature relating to SMEs, with the purpose of determining the aspects characterizing the auditing process wherein SMEs are the subjects.
b) **Phase 2:** this concerns the study of the audit risk approach

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in an SME, which is used by the auditor. The objective is to identify the so-called "auditing risk" in an SME, which is represented by the possibility that the judgement expressed by the auditor is inconsistent with what is inferable from the financial statement.

c) **Phase 3**: this concerns the creation of a theoretical model for reducing the audit risk in an SME, so that the opinion expressed by the auditor is as much in agreement with the information inferable from the financial statement as possible.

The paper does not use an empirical method; on the contrary, the above model would be used from practical implementation within an SME sample in the next stage of our research.

4. Findings

Below we present the findings of the research, with specific reference to the following objectives:

- Considering the audit risk approach in SMEs (refer to RQ1);
- Formulating a "model" to reduce audit risk in SMEs (refer to RQ2).

4.1 The audit risk approach in SMEs

The internal audit activity in an SME begins with the identification of the audit risk approach, as defined by ISA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" and ISA 330 "The Auditor's Responses to Assessed Risks", whose content seems to hinge on the evaluation of the risk.

With reference to *RQ1 - How is the audit risk approach dealt with in SMEs?* - the primary objective of the auditor is to identify the so-called "audit risk" within the company under examination; it presents the possibility that the opinion expressed by the auditor may be inconsistent with what can be inferred from the financial statement. It is hence hypothesized that the auditor did not realize that the financial statement was incorrect.

Within the audit risk approach, audit risk can be categorized according to the following key factors (see Figure 1)

a) *Intrinsic risk*: this relates to the possibility that an assertion concerning specific operations, disclosures or an account balance contains a substantial mistake. This factor is defined as intrinsic as it is strictly related to the nature of the item, irrespective of the internal control performed. For example, an assertion can present this risk characteristic because it is difficult or complex to evaluate. This depends on the company activity performed (for example, in a highly technological company, the value of unsold stock is characterized by an intrinsic risk which can widely and unexpectedly vary as a consequence of the obsolescence process it is characterized by), and on the fraud risk due to the scarcity of documented and standardized procedures.

b) *Control risk*: this risk component is linked to the possibility that a substantial mistake, either by itself or in combination with other items, is not promptly recognized and corrected by the company's internal control system. This case can be easily observed in SMEs, where internal control systems are often absent. In particular, mistakes that are most likely to be spotted are those arising due to a lack of control over the company's processes, by virtue of the scarcity of documentation and standardization of the procedures. On the contrary, mistakes linked to fraud prevention or to the employment of incompetent personnel are likely to be less frequent by virtue of the strict connection between the owner/manager and the company's personnel. In order for the auditor to correctly and efficiently analyse this risk component, he will need to understand how the company's internal control system works, what its characteristics and its action schedule are, how it can deal with and limit the company's risks, and what procedures have been implemented, and their actual validity and usefulness.

c) *Identification risk*: this is the risk that a significant mistake is not promptly identified by the auditor. The auditor may have failed to use all the procedures necessary to identify the mistake, or the procedures used might have not have been adequate.

The first two risk components (intrinsic and control risk) can be considered aspects of the audit risk that are not strictly related to the auditor and his actions. They depend on the company's internal situation, wherein the company may, either because of the complexity of its management or organization, or because of inaccuracies relating to its internal control system, end up providing financial statements which contain significant mistakes. These two parts of the audit risk are often presented and described as a whole, which is collectively defined as the "risk of significant mistakes"; this represents the risk that the financial statement, before being examined and controlled by the auditor, contain significant mistakes which make it untruthful or incorrect. Nevertheless, although we can definitely speak about a risk of significant mistake, nothing prevents the auditor from treating the two risk components separately, in the interests of pursuing a more in-depth and accurate analysis. On the other hand, the third risk component (identification risk) can be seen as an element that is solely connected to the auditor and his actions.

Figure 1 – The audit risk components: risk probability of an SME, versus the auditor's responsibility

Risk probability in a SME			
	High	**Control Risk**	
	Medium	**Intrinsic Risk**	**Identification Risk**
		Medium	High
		Auditor's responsibility	

Source: personal elaboration

As a consequence, audit risk can be observed according to its individual components, with reference to the following observation criteria:

- The risk probability in an SME;
- The auditor's responsibility.

In particular, it is clear that:

- SMEs do not present a higher predisposition to intrinsic risk compared to large companies;
- SMEs present a high predisposition to control risk, due to the frequent absence or inefficacy of an internal control system;
- The auditor's responsibility is high with regards to identification risk, whose probabilities are not raised by the SME.

After defining the audit risk components, some tools may be used to reduce this risk (also referring to ISA 315):

a) Implementation of a periodical comparative analysis: the smaller the company under examination, the more complex this procedure seems to be. In an SME, it is very unlikely that intermediate economic and/or financial reports will be available in order to analyse and compare developments within very short periods of time. Hence, the auditor must, when planning his actions, organize himself so as to be able to obtain documents which will allow him to evaluate the financial statement and their significant mistakes over a reasonable period of time prior to the final formulation of the statement itself.

b) Implementation of inquiry interviews with personnel and management: these staff members can suggest other ideas to the auditor. In an SME, where there are often

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no standardized procedures by which to measure economic and financial performance, such a tool can be very useful. The objectives here are multiple, and include understanding whether the company possesses an internal control system, and, if so, how it is organized; verifying whether there is a possibility of fraud risk or non-scrupulous behaviours on the side of the personnel and management, which can cause significant involuntary mistakes in the financial statement; and understanding whether the personnel or management operate in a way that is appropriate to the achievement of the company's objectives, in line with the relevant laws and regulations, and efficient coordination of the company's activities.

c) Assessment of the controls to be implemented: the auditor must be able to assess which and how many controls to implement, while considering that in an SME there will be a lower degree of separation among the company's various functions due to its reduced workforce. In relation to this, on the one hand, a unique owner/manager is in place, who can maintain close control over his employees, and, on the other, this lower degree of separation between functions can make the situation chaotic, and thus harder to control. In addition, not only procedures, but also the outcomes of the various controls and operations, often remain undocumented because of routines that favour the usage of verbal communication, which is more direct and faster than the drafting of paper reports that will often entail a timetable and other characteristics that are not typical of SMEs.

H1 is confirmed. Audit risk is an union of different type of risk, which can be more or less directly influenced by the activity of the auditor and such risk components influence each other. Every risk component can be more or less influenced by the small size of a SME.

4.2 A model to reduce audit risk in SMEs

In order to bring the audit risk down, the auditor must carry out accurate planning of his audit activity. This will necessarily have to result in the formulation of valid processes and activities that can be concretely implemented. However, even the delicate audit planning phase should consider the risks that are typical of the audit activity. For example, the auditor may incorrectly perform an audit procedure, or be unable to effectively carry out the planned auditing activity, or fail to correctly understand and interpret the inferred results.

Also, with reference to ISA 1005, "Special Considerations in the Audit of Small Entities", which deals with general aspects and strategic planning within smaller companies, it is necessary to analyse the essential components of audit risk to enable appropriate strategic planning activity. Such activity is an essential tool to frame the crucial areas within an SME and that, as a consequence, must be managed and controlled via procedures aimed towards correct risk management, which are able to pinpoint any mistake or issue considered important.

When executing the above-mentioned planning activities, the auditor will be able, depending on the complexity of the company under examination, to create an auditing team which will help him in his actions, in order to make supervision and control as simple and manageable as possible.

With reference to *RQ2 - How can the audit risk within SMEs be reduced according to the audit risk approach?* - the following specificities must be taken into consideration:

a) The factors characterizing the SME, which can influence the audit risk;
b) The planning tools used for the internal auditing activity;
c) The combined effect of the above-mentioned specificities (factors characterizing the SME and planning tools of the internal audit activity) within a model to reduce the audit risk in SMEs.

4.2.1 Factors characterizing SMEs

The typical characteristics of a SME, which may influence the audit risk, are related to the following aspects:

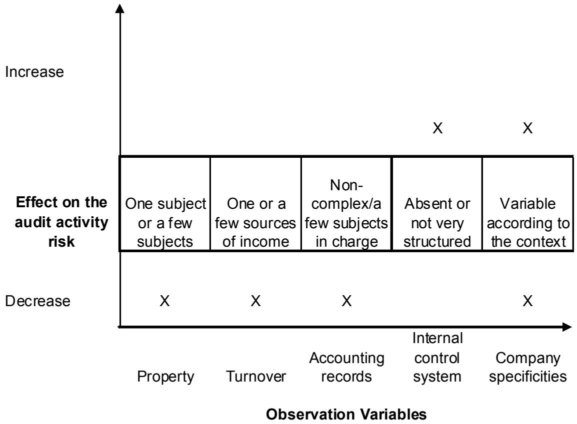
a) *Property*: generally, the company's property, like its management, is placed in the hands of only a few, and often just one individual. The owner is usually the person who is most involved in the daily management of his company. This is often beneficial to the management and planning of the audit activity, as the property subjects to check are limited (often represented by a unique subject);
b) *Turnover*: the sources of turnover are generally limited in number – often there is just single income-generating activity. The same can be said about the end market, of which, as for income, there is generally only one. Again, this is often beneficial to the management and planning of the audit activity, as the auditor will easily be able to gain information on the sector and the company's market, given the limited complexity of this element.
c) *Accounting records*: within an SME, accounting is generally simpler than in a large company, and is characterized by limited types of movements. Thus, accounting records are generally not complex and are entrusted either to a small number of operators, or to an external professional who manages the business accounting in its entirety. The auditor has to ensure that all accounting movements are registered correctly and accurately, and verify the contingent fraud risk. This can be easier if the company uses standardized and amply tested accounting software, which can serve to guarantee the reliability of the information and the accounting system. The use of adequate software for accounting management is declared to be extremely relevant in ISA 1005, "Special Considerations in the Audit of Small Entities".
d) *Internal control system*: if present, internal control systems in SMEs tend not to be very structured, and seem to be very basic in their composition; often, it is the up to the owner/manager to carry out the control. Where an internal control system is present, its weaknesses will be compensated by the dedication and attention of the owner/manager: given his predominant position, he will have actual control over all decisions and will be able to personally intervene to correct or modify certain aspects considered not useful for good business management. As a consequence, the risks of mistakes or fraud on the side of the employees is reduced, controlled and supervised by the owner himself, who looks after the company's interests. Similarly, the fact that there is just one person who signs payment orders represents a huge guarantee regarding the purchase area, which again is an element that must be accurately controlled. However, there are also negative aspects of this owner control. For example, his position could enable him to make payments that are not supported by the appropriate documents, or, in general, promote ethically unfair behaviours – hence the need for an auditor.
e) *Company specificities*: every company has its own specificities which influence their efficiency. The auditor will have to carefully study the specific reality of the company in question, whose singular elements may create criticality, thereby increasing the audit risk.

From the considerations above, it is clear that the elements characterizing SMEs have a number of effects on the audit activities within them (see Figure 2), as follows:

a) Elements which decrease the difficulty level of the audit activity in SMEs include: property, turnover and accounting records; these generate low criticality in the auditor's activity, thereby limiting the risk;
b) Elements which increase the difficulty level of the audit activity in SMEs include: the internal control system, which is often absent or rather limited, meaning that there is a limited amount of information at the auditor's disposal.

c) Elements which can decrease or increase the difficulty level of the audit activity in SMEs include: the individual company specificities.

Figure 2 – The effects of the characterizing elements of SMEs on audit activity



Source: personal elaboration

4.2.2 The planning of internal auditing activity in SMEs
The first element which an auditor has to evaluate in the context of strategically planning his activity is the analysis of the business context in which the accounting control is being performed; only after this aspect has been clarified will it be possible to move on to the actual audit activity. The planning process is influenced by objective and subjective aspects. With reference to the objective ones, the planning varies according to the company's size and structure, and the complexity of the sector or the market in which it operates. With reference to the subjective aspects, this activity varies depending on the auditor's knowledge on the company, sector, market, etc.

The strategic planning activity in an SME places the audit risk limitation at a reasonably low level, and is based on the following tools:
a) The general audit strategy;
b) The detailed auditing plan.

A) The general audit strategy
The general audit strategy must lead the auditor to a correct evaluation of the risk, which, through adequate and specific procedures, may finally lead to the creation of a correct and truthful judgement and report. Thus, the following elements must be defined as part of the audit strategy:

- The range and extent of the activities to be performed;
- The characteristics of the task taken on;
- The accounting and financial laws relevant to the company, including the contingent specificities and obligations linked to the sector in which the controlled subject operates;
- The critical areas of the company, in which greater controls are needed because of a greater inclination towards risk, which is either intrinsic or control risk;
- The specific procedures needed in order to evaluate the efficacy of the internal control system, whenever present;
- The level of significance of errors and imprecisions;
- The auditor's objectives and deadlines. To this end, he could plan a series of periodical controls to be conducted during the year, which can be particularly relevant for the controlled company and the resources the auditor intends to use when performing his task;
- The nature, timetable and quantity of the resources necessary to correctly perform the external audit.

After the above objectives have been outlined, along with action timetables and the tools/resources necessary to work in an efficient and effective way, the auditor should have achieved a valid overview of the company, and identified the critical areas and issues that could arise during the audit.

B) The detailed auditing plan
Subsequently, the auditor must elaborate a *detailed auditing plan*, in which he will evaluate in detail the nature, timetable, and extent of the planned audit procedures and possible changes, where applicable. An appropriate and detailed auditing plan will present two different typologies of possible procedures:

a) *Conformity procedures:* as reiterated by audit principle 500, "Audit Evidence", it is necessary to analyse and evaluate the actual efficiency of the internal control system used by the company itself, with the aim of reducing mistakes and inaccuracies. In a smaller company, the auditor may observe that not all of the control activities previously considered necessary are concretely implemented by the company's internal control system. In fact, these procedures can be performed through the combined use of processes such as:
- Analysis and verification of the available documents;
- Inspection of the company's premises or documents or warehouses;
- Meetings with the employees or the owner;
- Analysis of the modus operandi of the internal control system, including verifying the orderliness and the uniformity of its activities;
- Re-execution of control processes already carried out by the internal control system, with the purpose of evaluating contingent gaps in the results achieved and hence testing the above-mentioned system.

b) *Validity procedures*: as reiterated by audit principle 330 "The auditor's responses to assessed risks", validity procedures should be carried out because the evaluation of the risk on the side of the auditor is a subjective element. Hence, we want to make sure there are no significant risks which have not been correctly evaluated due, for example, to limitations or inefficiencies in the internal control system. Validity procedures include:

- Comparative analysis procedures: as stated by audit principle ISA 520, these lead to a comparison and analysis of the gaps between particular typologies of data. Generally, they are used to evaluate the company's financial and economic information. These procedures enunciate contingent existing relationships among the same data during different years, or among the results achieved by companies operating in similar markets (for example, comparing the duration of the company's credits to customers against the average index of the reference sector), or even comparing the company's evaluations found in estimated budgets or forecast financial statements with those calculated by the auditor (for example evaluations of amortization calculations, or the totals of provisions for risks and charges). The actual execution of such procedures can vary according to the complexity of the situation, ranging from a basic comparison of different data to a complex analysis based on particular statistical techniques. These procedures are used in the audit planning phase, as they seem to be extremely useful for tracking down significant elements and factors that would otherwise remain undiscovered. This contributes to establishing the nature, size and timetable of other audit processes. Not only it is possible to compare economic and financial data, but the auditor is also given the faculty of making the most of whatever data he deems to be significant: for example, it may be useful to compare the turnover with the retail area, or even compare the income with the amount of goods sold. Broadly, the use of such procedures should bring to light contingent gaps which could represent hidden risk factors that had not yet

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been identified.

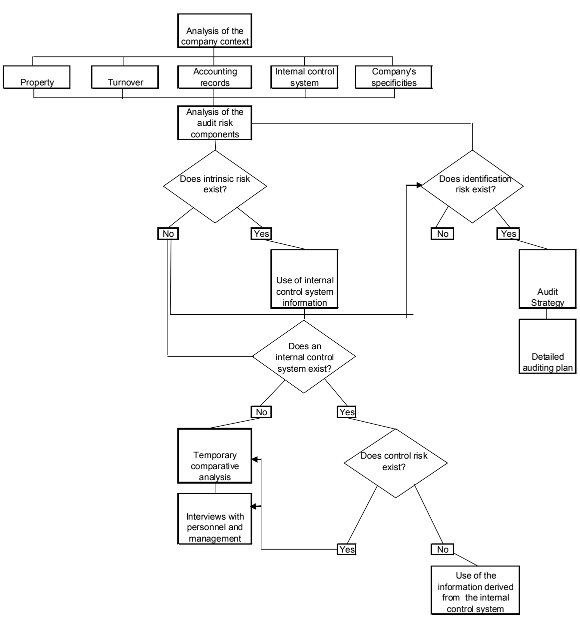
- Detailed analyses, either oriented towards the account balances or operations: these represent direct checks regarding the collection of audit evidence and the comparison of these with documented proofs, as well as the physical activities that are dependent on them. Such proofs are found through several modalities, including requesting demonstrations on the truthfulness of account balances or financial statement items by asking for external confirmations (for example, via communications with customers and suppliers to verify account balances concerning their debits and credits towards the company analysed, or with banks to prove that the bank checking account or the debt position concerning hypothetical mortgages matches that provided by the company); inspecting the company's premises (in certain cases it is essential to physically check the warehouse; because of the large amount of time required to do this, the process needs its own accurate controls, as, depending on the company's needs, they will often use the warehouse to inflate too-low profits or reduce too-high profits, which would call for likewise high taxes); or, with third parties, checking whenever deposits of goods external to the company are declared, or consignment goods are physically transferred to customers on consignment.

4.2.3 Articulation of a model of audit risk reduction in SMEs

After examining the factors characterizing SMEs which can influence the audit risk, and outlining the planning tools used for the internal audit activity, a model for reducing the audit risk in SMEs can be outlined. This model is characterized by the following variables:

a) Context and specificity of the company under examination;
b) Impact of the risk of significant errors;
c) Presence of an internal control system;
d) Relations between the various risk typologies;
e) Effective audit strategy and audit activity planning.

The model for audit risk reduction is shown in Figure 3.
3 – Model of audit risk reduction



Source: personal elaboration

The model can be articulated in the following steps:

Step 1. Identification of the company context. Here, the auditor has to analyse the context with particular reference to the following variables: number of subjects that represent ownership; sources of origin of turnover; accounting records; characteristics and functions of the internal control system; and company's contingent specificities. Every element can influence the audit risk approach, as they each represent critical elements that can make the auditor's job more or less difficult. It is necessary to consider the presence of elements which decrease the difficulty level within the audit activity of the SME (property, turnover, accounting records), other elements which increase the difficulty level of the auditing activity (the internal control system), and additional aspects which can either decrease or increase the difficulty level of the audit activity, depending on the company's specificities.

Step 2. Decomposition of the audit risk system. This system includes the following risk components: intrinsic risk, control risk and identification risk:

1) The auditor verifies the presence of an intrinsic risk:
1a) If there is no intrinsic risk, he continues to the identification of the other two risk components (control risk and individuation risk);
1b) If there is an intrinsic risk, there is a possibility that an assertion relative to specific operations, disclosures or a ledger account balance contains a mistake which may be significant. He should obtain relevant information produced by the internal control system. The possible scenarios here are as follows:
i) An internal control system does not exist: it is then necessary to use alternative tools, such as temporal comparative analysis and interviews with personnel and management.
ii) An internal control system exists: it is necessary to ask whether, besides the existence of the internal control system, there is a control risk.
- If there is no control risk: the auditor will have to use the information derived from the internal control system.
- If there is a control risk: there is a possibility that a mistake might be significant, either by itself or combined with other entries, is not promptly recognized and corrected by the company's internal control system. First, the auditor must understand the extent of the discipline of the company's internal control system, as well as its characteristics, timetables, validity, and the procedures used and their actual usefulness. With the existence of a control risk, the auditor will need to make use of a series of alternative tools, such as temporary comparative analysis and interviews with personnel and management.
2) The auditor verifies the existence of identification risk.
2a) If there is an identification risk, a significant mistake is not promptly identified by the auditor. The auditor may have failed to use all of the procedures necessary to identify the mistake, or the procedures used might not have been adequate. In order to reduce this risk, it is useful to identify and follow an auditing strategy and a detailed auditing plan, as described in section 4.2.2.
2b) If there is no identification risk: this indicates that the risk has been reduced by following the previous stages of the model.

This model is strongly influenced by the interrelation between the audit risk components (intrinsic risk, control risk and identification risk) (see Figure 4).

- Control risk and intrinsic risk are directly proportional: the less accurate the internal control system, the higher the intrinsic risk, as there is an increased possibility that evaluation mistakes could arise with reference to assertions concerning specific operations, disclosures or account balances.
- The bond between intrinsic and control risk manifests indirectly within individuation risk: while, at least theoretically, identification risk strongly depends on the auditor, who might not have put to use all the procedures

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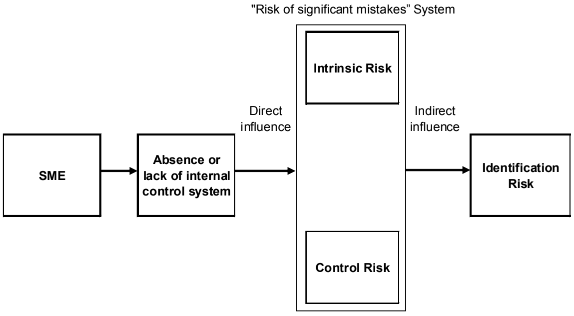
necessary to identify the mistake, on the other hand the procedures used by the auditor might not have been adequate, perhaps even due to the manifestation of intrinsic and control risk, which, in SMEs, are rather common. As a consequence, other things being equal, the bond between intrinsic and control risk can be intended as a condition for the presence of identification risk.

Figure 4 – The interrelations between the components of audit risk



Source: personal elaboration

Conclusion

This paper analysed the risk audit approach and delineated a model for the reduction of audit risk. This confirms the validity of the fundamental rules characterizing audit activity in an SME, as also reiterated by ISA 330:

a) "Irrespective of the risks of significant mistakes identified and considered, the auditor must define and carry out validity procedures for every significant class of operations, account balances and information". It is considered mandatory to use validity procedures for all financial statement items or operations which, even simply by their own nature, can be considered significant.
b) "If the auditor has established that a risk of a significant mistake, identified and evaluated, concerning the assertions, represents a significant risk, he must carry out those validity procedures specifically respondent to that risk. In case the approach towards the significant risk was merely based on the validity procedures, such procedures must include a detailed analysis." This specifies how, in cases where significant elements are found which may turn into risks, and hence significant mistakes, not only are validity procedures necessary, but they must also be confirmed through detailed tests.

The auditor must carry out the auditing activity to certain timetables, while adequately documenting the various cases encountered, and certifying his general strategy and detailed auditing plan.

However, with reference to SMEs, the assertions may be evaluated in a simpler way, given the specificity of the business context. Specifically, the assertions in an SME will generally concern:

a) Completeness: in the financial statement, all movements and elements should be observed; that is, there are no pending or incorrectly registered operations;
b) Existence: every single element or item presented in the financial statement exists, has manifested itself and refers to the company;
c) Accuracy: all the elements on an income statement and balance sheet, as well as the information pertaining to them, actually concern the company and have been evaluated correctly;
d) Evaluation: the balance sheet and income statement items are presented with exact values, and have been obtained by implementing the appropriate valuations and corrections required by law.

The ability and the aptitude of the auditor is a determining factor in the reduction of audit risk; in fact, in the execution of his actions, he must be able to identify and analyse the risks of significant mistakes not only in the financial statement in its entirety, but also for every single assertion.

A model for limiting the audit risk in an SME must consider a series of factors related to the individual SME, including the following: the context and specificity of the company under examination; the impact of intrinsic risk; the presence of an internal control system; the presence of a control risk; and the ability of the auditor to carry out attentive and correct planning of the internal audit activity in the SME. Only by formulating an effective general auditing strategy can the auditor completely evaluate the audit risk, thereby allowing him to delineate a correct and truthful evaluation of the audit. In addition, a detailed auditing plan allows the auditor to evaluate the nature, timetable and extent of the planned audit procedures, especially considering the individual company's specificities.

After examining the factors characterizing SMEs, what can be noted is the absolute improbability of a previously established process by which to evaluate and correct the risk factors in the SME. This is due to the fact that it is usually the management that carries out its own control activity, because of its direct involvement in the company's activity. Also, it is sensible that, regardless of the circumstances of the company under consideration, the auditor will always perform an investigation of the possible risks and understand how the company's management would hypothetically deal with them.

The implications of our paper is connected to the purpose of the outlined model to reduce audit risk in SMEs. Although it is not humanly impossible to completely abolish significant risks and mistakes, they can definitely be brought to a lower level. To this end, the auditor possesses diverse tools which can help to contain the risk of significant mistakes including those made unintentionally, and those originating from fraudulent behaviour within the company.

To reduce the limitations of our paper, it would be interesting to apply the outlined model of reducing audit risks to a sample of SMEs. This application may quantify an higher correct and truthful disclosure, also improving the interactions between company and stakeholders.

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