

AUDIT RISK

E-Module

Session Objective

- Understand what is Audit Risk
- How Risk assessments are made
- Responses to audit risks
and in the process,
- Familiarize ourselves with relevant ISSAI/ISA

Kindly Note:

Relevant ISSAI/ISA are hyperlinked at the end of the slide and can be accessed through the hyperlinks

Introduction

Identifying and assessing audit risk is a key part of the audit process, and ISA 315/ISSAI 1315, *'Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment'*, gives extensive guidance to auditors about audit risk assessment. The purpose of this E-Module is to give summary guidance to about the concept of audit risk.

WHAT IS AUDIT RISK?

According to the IAASB Glossary of Terms (1), audit risk is defined as follows:

‘The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk.’

WHY IS AUDIT RISK SO IMPORTANT TO AUDITORS?

Audit risk is fundamental to the audit process because auditors cannot and do not attempt to check all transactions. It would be impossible to check all transactions, and no one would be prepared to pay for the auditors to do so, hence the importance of the risk-based approach toward auditing. Traditionally, auditors have used a risk-based approach in order to minimise the chance of giving an inappropriate audit opinion, and audits conducted in accordance with ISAs/ISSAIs must follow the risk-based approach, which should also help to ensure that audit work is carried out efficiently, using the most effective tests based on the audit risk assessment. Auditors should direct audit work to the key risks (sometimes also described as significant risks), where it is more likely that errors in transactions and balances will lead to a material misstatement in the financial statements. It would be inefficient to address insignificant risks in a high level of detail, and whether a risk is classified as a key risk or not is a matter of judgment for the auditor.

RELEVANT ISAs / ISSAIs

There are many references throughout the ISAs / ISSAIs to audit risk, but perhaps the two most important audit risk-related ISAs are as follows:

ISA 200/ISSAI 1200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs /ISSAIs

ISA 200/ISSAI 1200 sets out the overall objectives of the auditor, and the standard explains the nature and scope of an audit designed to enable an auditor to meet those objectives. References to audit risk are frequently made by ISA 200 / ISSAI 1200, and the standard also requires that the auditor shall plan and perform an audit with professional scepticism, recognising that circumstances might exist that may cause the financial statements to be materially misstated.

Professional scepticism is defined as an attitude that includes a questioning mind and a critical assessment of evidence.

RELEVANT ISAs / ISSAIs contd.....

ISA 315 / ISSAI 1315, Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment

ISA 315 /ISSAI 1315 deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through an understanding of the entity and its environment, including the entity's internal controls and risk assessment process.

The requirements of ISA 315 /ISSAI 1315 are summarised as the following

- 1) The auditor shall perform risk assessment procedures in order to provide a basis for the identification and assessment of the risks of material misstatement.
- 2) The auditor is required to obtain an understanding of the entity and its environment, including the entity's internal control systems.
- 3) The auditor shall identify and assess the risks of material misstatement, and determine whether any of the risks identified are, in the auditor's judgement, significant risks. This is in order to provide a basis for designing and performing further audit procedures.
- 4) ISA 330 / ISSAI 1330 then deals with the required responses to assessed risks.

**Let us consider the four
stages in more detail**

1. Risk assessment procedures

ISA 315/ ISSAI 1315 gives an overview of the procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered when designing the audit plan. ISA 315 / ISSAI 1315 goes on to require that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. ISA 315 goes on to identify the following three risk assessment procedures:

1. Making inquiries of management and others within the entity
2. Analytical procedures
3. Observation and inspection

Making inquiries of management and others within the entity

Auditors must have discussions with the client's management about its objectives and expectations, and its plans for achieving those goals.

Analytical procedures

Analytical procedures performed as risk assessment procedures should help the auditor in identifying unusual transactions or positions. They may identify aspects of the entity of which the auditor was unaware, and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

A separate E-Module has been prepared by RTI, Kolkata with detailed discussions on Analytical Procedures.

Observation and inspection

Observation and inspection may also provide information about the entity and its environment. Examples of such audit procedures can potentially cover a very broad area, including observation or inspection of the entity's operations, documents, and reports prepared by management, and also of the entity's premises and plant facilities.

Risk assessment procedures

ISA 315/ISSAI 1315 requires that risk assessment procedures should, at a minimum, comprise a combination of the above three procedures, and the standard also requires that the audit team members should discuss the susceptibility of the entity's financial statements to material misstatement. Key risks can be identified at any stage of the audit process.

2. Understanding an entity

ISA 315 / ISSAI 1315 gives detailed guidance about the understanding required of the entity and its environment by auditors, including the entity's internal control systems. Understanding of the entity and its environment is important for the auditor in order to help identify the risks of material misstatement, to provide a basis for designing and implementing responses to assessed risk (see reference to slides below on ISA 330 / ISSAI 1330, 'The Auditor's Responses to Assessed Risks'), and to ensure that sufficient appropriate audit evidence is collected. Given that the focus of this e-module is audit risk, however, reader should ensure that they also make themselves familiar with the concept of internal control, and the components of internal control systems.

3. Identification and assessment of significant risks and the risks of material misstatement

In exercising judgement as to which risks are significant risks, the auditor is required to consider the following:

- ✓ Whether the risk is a risk of fraud.
- ✓ Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires specific attention.
- ✓ The complexity of transactions.
- ✓ Whether the risk involves significant transactions with related parties.
- ✓ The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- ✓ Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

4. ISA 330 / ISSAI 1330 and responses to assessed risks

Essentially ISA 330 / ISSAI 1330 gives guidance about the nature and extent of the testing required, based on the risk assessment findings.

Paragraph 6 of ISA 330/ISSAI 1330 requires that:

‘The auditor shall design and perform further audit procedures whose nature, timing, and extent are based upon and are responsive to the assessed risks of material misstatement at the assertion level.’

Tests of Control and Substantive Procedures

Test of control	Substantive procedure
An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.	An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details and substantive analytical procedures.

Tests of Control and Substantive Procedures

One often find it quite difficult to comprehend what tests of control and substantive procedures are, to explain the difference between them, and also to give examples of both. One important difference between them is that tests of control are usually short, quick tests which generate either a 'yes' or a 'no' answer, where 'yes' is favourable (confirming the operation of an internal control), and 'no' is unfavourable (indicating that an internal control is not operating satisfactorily). Substantive procedures, however, as the name suggests, are more substantive and time consuming, requiring more detailed audit work to be carried out. The following examples, in the context of a purchases system, should help.

TESTS OF CONTROL – EXAMPLES FOR A PURCHASES SYSTEM

Consider when the auditor reviews a company's purchases system and internal controls, and the assertion of occurrence (that recorded purchases represent goods and services received and which pertain to the entity). An appropriate internal control would be that purchase orders are raised for each purchase and are authorised by appropriate senior personnel.

A test of control would be to examine a sample of purchase orders to ensure that they have been appropriately authorised, and a 'yes' answer is good, confirming that the internal control requiring authorisation of purchase orders is working, or alternatively a 'no' answer indicates that the internal control does not appear to be working, hence requiring further audit investigation.

TESTS OF CONTROL – EXAMPLES FOR A PURCHASES SYSTEM

Another example of a test of control for a purchases system would be to inspect a sample of goods received notes to confirm that stores inwards staff sign for goods received. Once again, a 'yes' answer is positive, confirming that staff have signed the goods received note, and a 'no' answer would be negative, requiring further audit work to be carried out to determine why the goods received note had not been signed. This test of control would also help to confirm the occurrence assertion.

SUBSTANTIVE PROCEDURES AND TESTS OF DETAIL – OVERVIEW

ISA 330/ISSAI 1330 requires that the auditor shall always carry out substantive procedures on material items irrespective of the assessed risks of material misstatement, and that the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. According to the IAASB Glossary of Terms 1, substantive procedures fall into two categories, 'tests of details' and 'substantive analytical procedures' (or simply 'analytical procedures', as they are usually described). ISA 330/ ISSAI 1330 says that auditors must decide when it is most appropriate to use which type of substantive procedure. Analytical procedures are outside the scope of this e-module (separate e-module prepared), and the examples given below are examples of tests of details.

Substantive procedures – examples of tests of detail for a purchases system

Substantive procedures will invariably tend to involve more work than tests of control.

Consider once again the example of the purchases system for a manufacturing company and the assertion of existence for account balances in the statement of financial position. Typical tests of detail would involve some physical verification of year-end balances outstanding, which would require obtaining and reviewing the closing purchase ledger account balances for a sample of purchase ledger accounts with selected suppliers. Typically, this could include agreeing the closing balance figure to the supplier's statement, or even possibly requesting third party confirmation by the supplier of the amount outstanding.

Substantive procedures – examples of tests of detail for a purchases system

Cut-off testing would also be typically carried out on year-end purchase ledger balances, which would involve obtaining a sample of pre- and post - year-end goods received notes, and agreeing these to the matching pre- or post-year-end purchase invoices, to ensure that only goods received before the end of the accounting period were included. This test would also help to confirm the assertion of existence.

TIMING

ISA 330 / ISSAI 1330 indicates that the auditor may perform tests of control or substantive procedures at an interim date or at the period end. The standard also indicates that, in general, the extent of audit procedures increases as the risk of material misstatement increases.

OVERALL RESPONSES

ISA 330 / ISSA 1330 lists the following overall responses that may be used by auditors in order to address the assessed risks of material misstatement at the financial statement level:

- ✓ Emphasising to the audit team the need to maintain professional scepticism.
- ✓ Assigning more experienced staff, those with special skills, or using experts.
- ✓ Providing more supervision.
- ✓ Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- ✓ Making general changes to the nature, timing or extent of audit procedures.

**More discussions on
Risks.**

AUDIT RISK AND BUSINESS RISK

ISA 315 / ISSAI 1315 defines business risk as follows:

‘A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.’

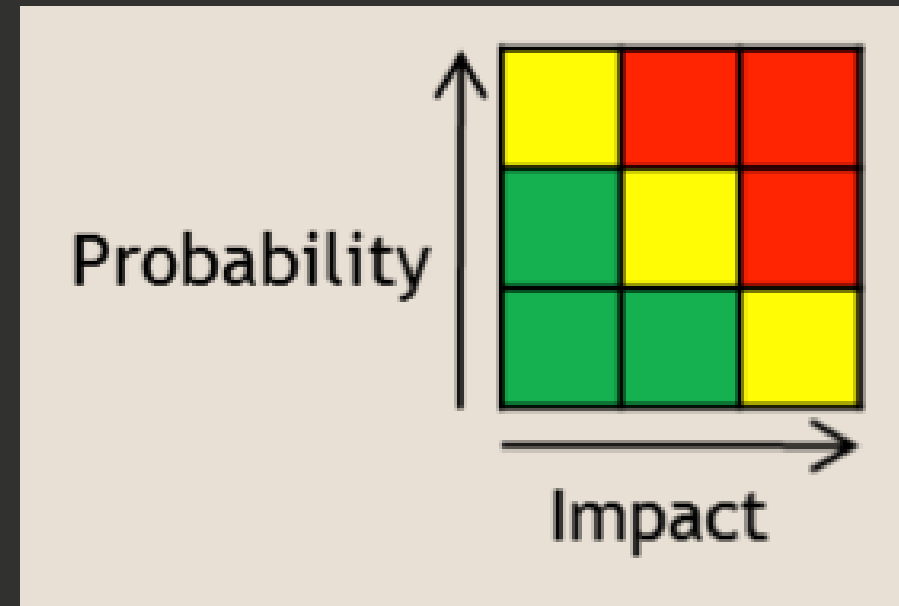
Hence, business risk is a much broader concept than audit risk.

THE AUDIT RISK MODEL

Finally, it is important to make reference to the so called traditional audit risk model.

The audit risk model breaks audit risk down into the following three components:

- ❖ Inherent risk
- ❖ Control risk
- ❖ Detection risk



Inherent risk

This is the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inherent risk: controlled by client ... function of type of business, degree of liquidity, complexity

Inherent risk

Inherent Risk Factors:

- (1) nature of activities (complexity)
- (2) regulatory nature
- (3) degree of estimates
- (4) competency and training of those reporting the financial statements
- (5) previous history with entity

Control risk

This is the risk that a misstatement could occur in an assertion about a class of transaction, account balance or disclosure, and that the misstatement could be material, either individually or when aggregated with other misstatements, and will not be prevented or detected and corrected, on a timely basis, by the entity's internal control.

Control risk: controlled by client ... relates to effectiveness of client's control system in preventing, detecting, and correcting errors.

Control risk

Control risk is linked with the entity's internal control factors such as:

1. **Control Environment**-sets the tone for the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control.
2. **Risk Assessment**-the identification and analysis of relevant risks to the achievement of objectives, forming a basis for how the risks should be managed
3. **Information and Communication**-systems or processes that support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities
4. **Control Activities**-the policies and procedures that help ensure management directives are carried out.
5. **Monitoring**-processes used to assess the quality of internal control performance over time.

Detection risk

This is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk: controlled by auditor ... function of nature, timing, and extent of audit procedures applied ... allowable or acceptable

Audit risk = inherent risk X control risk X detection risk

The Auditor has limited role in reducing inherent risk or control risk. They are the Management's responsibility. The Auditor can reduce Audit Risk by reducing detection risk. Because the above model is multiplicative in nature, if detection risk can be brought down to zero (theoretical consideration, in practice it is impossible) then by multiplying with zero, the resultant Audit Risk is also zero.

To ensure that overall audit risk is within an acceptable level, auditor will have to collect more evidence to satisfy itself of Management's assertions when inherent risks or control risks are assessed to be higher.

Kindly note that the Audit Risk model is prepared to drive home the point that higher degree of scrutiny is needed for complex transactions (inherent risk) or when there are poor internal control in the entity being audited (control risk). In practice, numerical calculations seldom done.

ISA/ISSAI referred in the E-Module

ISA No.	ISSAI No.	Content
		<u>IAASB Glossary of Terms.</u>
200	1200	<u>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</u>
315	1315	<u>Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</u>
330	1330	<u>The Auditor's Responses to Assessed Risks</u>

Disclaimer

Kindly note that the purpose of this e-module is to broadly introduce the reader to the concept of Audit Risk and the relevant ISSAI/ISA. This is not a substitute of the ISSAI/ISA and the reader is requested to read these standards hyperlinked in the previous slide.

The readers are also requested to keep themselves informed about current developments in risk based auditing both within IA&AD and beyond.

Further queries may please be email at:

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THANK YOU