

Assessing Audit Risk

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**GENERAL CONFERENCE AUDITING SERVICE
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Ann Gibson, PhD, CPA
Andrews University

Types of Risk

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Risks associated with an audit:

- Business Risk
- Financial Reporting Risk
- Audit Risk

Business Risk

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The risk that affects the operations and potential outcomes of organizational activities. Business risk comes from:

- Economic climate
- Technological change
- Competition
- Complexity of transactions
- Geographic location
-
-

Financial Reporting Risk

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Risks that relate directly to the recording of transactions and the presentation of financial data in the financial statements. Financial reporting risk comes from:

- Complex and subjective accounting transactions
- Competence and integrity of management
- Incentives for management to misstate financial statements
- Human error
- Inadequate internal controls

Audit Risk

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The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Audit Risk May Be Controlled

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- May avoid audit risk by not accepting clients who are risky.
- May set audit risk at a level that mitigates the likelihood that the auditor will fail to identify material misstatements.

Setting Audit Risk

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- May be set quantitatively: 1% or 5%
- May be set qualitatively: “high” “medium” “low”

Setting Audit Risk

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General Observation:

The amount and persuasiveness of audit evidence gathered should vary inversely with the audit risk.

Lower audit risk (i.e., 1% or “low”) requires gathering more persuasive evidence.

Audit Risk Defined

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$$\mathbf{AR = IR \times CR \times DR}$$

Where:

- AR = audit risk
- IR = inherent risk
- CR = control risk
- DR = detection risk

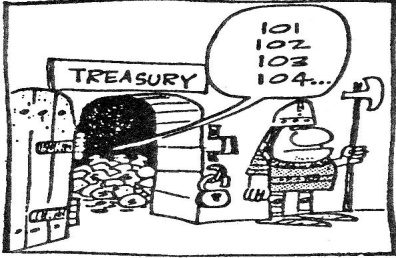
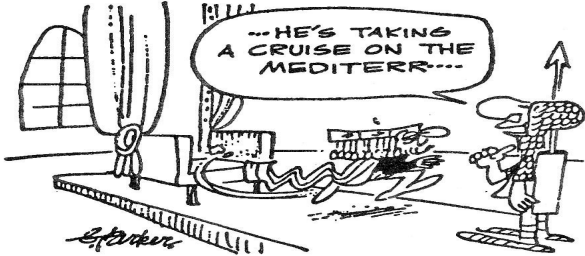
Inherent Risk

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Definition:

The initial susceptibility of a transaction or accounting adjustment to be recorded in error, or for the transaction not to be recorded in the absence of internal controls.

Inherent risk recognizes that an error is more likely to occur in some areas than in others.



Inherent Risk

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Factors that affect inherent risk:

- Complexity of accounting issue or the calculation.
- Misstatements in prior periods.
- Susceptibility of the asset to theft.
- Expertise of the accounting personnel.
- Volume of transactions.

Control Risk

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Definition:

The risk that the client's internal control system will fail to prevent or detect a misstatement.

Control Risk

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Auditor must evaluate the design of the control and determine whether it has been placed in operation.

Is the control capable of effectively preventing a material misstatement? Of effectively detecting and correcting a material misstatement?

Is the entity using the control?

Control Risk

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General Observation:

The better the organization's internal controls, the lower the likelihood of material misstatements.

Control Risk

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Second Standard of Fieldwork:

The auditor must obtain a sufficient understanding of the entity and its environment, **including its internal control**, to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

Control Risk

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General Observation:

The auditor should not rely too heavily on either the client's internal controls nor on their audit procedures to detect errors or frauds in the financial statements.

Detection Risk

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Definition:

The risk that the audit procedures will fail to detect a material misstatement.

Detection Risk

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The auditor can control/manage detection risk through:

- Careful audit planning.
- Effective audit procedures.
- Performing those procedures with due professional care.

Detection Risk

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Example:

- Audit risk = 0.01 (high)
- Inherent risk = 100%
- Control risk = 100%

$$DR = AR / (IR \times CR) = .01 / (1.0 \times 1.0) = 1\%$$

Client does not have effective internal control; high risk that a transaction would be recorded incorrectly.

Detection Risk

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Conclusion:

Poor controls and a high likelihood of misstatement lead to extended audit work to maintain audit risk at an acceptable level.

Detection Risk

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Example:

- Audit Risk = 0.05 (low)
- Inherent Risk = 0.50
- Control Risk = 0.20

$$DR = AR / (IR \times CR) = .05 / (.50 \times .20) = 50\%$$

Client has simple transactions, well-trained staff; no incentive to misstate; effective internal control

Detection Risk

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Conclusion:

Only minimal substantive tests of account balances are needed to provide corroborating evidence on the expectations that the accounts are not materially misstated. **However, the auditor must test whether the controls were operating effectively in order to support a control risk assessment below 100%.**

Limitations of the Audit Risk Model

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1. Inherent risk is difficult to formally assess.
2. Audit risk is judgmentally determined.
3. The model treats each risk component as separate and independent.
4. Audit technology is not so precisely developed that each component of the model can be accurately assessed.

Materiality

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Audit risk and detection risk go hand in hand with materiality. The size of the misstatement matters.

Materiality deals with the relative importance of matters, individually or in the aggregate, for fair presentation in the financial statements.

Understanding the Client

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Understanding the client includes the following:

- Industry, regulatory and other external factors.
- Nature of the entity and its operations.
- Objectives, strategies and related business risks.

Understanding the Client

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- Measurement and review of the entity's financial performance.
- Internal controls, specifically those relating to the entity's objective of preparing financial statements in conformity with GAAP.

Understanding the Client

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Quiz Time: Andrews University

Understanding the Client

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Procedures to obtain an understanding of the client:

- Inquiries of management and others.
- Analytical procedures.
- Observation of activities.
- Inspection of documents.



“Basically my job is to receive the buck, make copies of it, classify it, crossreference it, record it, and then pass it on.”

Cartoon by Ed Arno; © 1991, *Harvard Business Review*. Reprinted by permission of Ed Arno.

Internal Control

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The auditor requires sufficient understanding to:

- Identify types of potential misstatements.
- Consider factors that affect the risks of material misstatements.
- Design tests of controls, when applicable, and substantive procedures.

Internal Control

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Special audit consideration may be required if:

- There is risk of fraud.
- There are risks associated with recent significant economic or accounting developments.
- The transactions are complex either due to accounting principles or complex calculations.

Internal Control

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- There are significant related-party transactions.
- There is subjectivity in the measurement of financial information, including measurement uncertainty.
- Significant non-routine transactions exist which are outside the normal course of business and therefore outside the normal effective controls.

Internal Control

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Five elements of control:

1. The control environment
2. The entity's risk assessment
3. Control activities
4. Monitoring of controls
5. The information and communications systems

Internal Control

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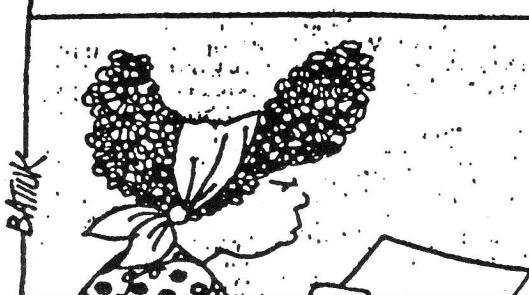
Two types of control deficiencies:

- Design deficiencies
 - A control is missing
 - A control is not properly designed to work even if operating
- Operational deficiencies
 - A control does not operate as designed
 - Person performing control is unqualified or untrained

DEFINE THE FOLLOWING:



RUNNING BALANCE



An accounting term
that refers to times
when you have to
run to the bank to
cover the checks you've
written!



Documentation

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Discussion among audit team members regarding audit risk should be documented.

Documentation should include how and when the discussion occurred, who participated, the significant decisions reached related to the audit planning process and the basis for that assessment.

Documentation

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Appropriate responses to the discussion include:

- Emphasizing the need to maintain professional skepticism.
- Assigning more experienced staff or those with specialized skills.

Documentation

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- Using a specialist.
- Providing more supervision.
- Incorporating unpredictability into the selection of the audit procedures to be performed.
- Changing the nature, timing, and extent of further audit procedures.

Practice Case

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In the practice case, YOU are the architect of the audit of Adventist Academy's Accounts Payable.

What is the audit risk by assertion?

What is the inherent risk?

What is the control risk?

What is the detection risk?

How would you change the basic audit program?

Practice Case

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Financial Statement Assertions:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Accuracy or classification
- Cutoff

Inherent Risk Assessment Worksheet

Audit Area ^a	Risk Assessment Approach ^b	Inherent Risk Factors									Comments
		Engagement Risk ^c	Accounting Issues ^d	Auditing Issues ^e	Prior Period Misstatements ^f	Susceptibility to Fraud ^g	Accounting Personnel ^h	Need for Judgment ⁱ	Nature of Items ^j	Complexity ^k	
Other	By Audit Area:										
	or By Assertion:										
	E/O										
	C										
	R/O										
	V										
	A/CL										
	CO										

Notes

- ^a The risk assessment approach used for each audit area should agree with your documentation on Form PN-11 (Risk Assessment Summary Form).
- ^b The risk assessment approach used for each audit area should agree with your documentation on Form PN-11 (Risk Assessment Summary Form).
- ^c The effect on the audit area of risk factors that were identified on Forms PN-2, PN-3.1, or PN-6 (Risk Identification Worksheet).
- ^d The complexity and contentiousness of accounting issues affecting the audit area.
- ^e The frequency or significance of difficult-to-audit transactions affecting the audit area.
- ^f The nature, cause, and materiality of misstatements detected for the audit area in prior audits.
- ^g The susceptibility of the audit area to fraud, including both misappropriation of assets and fraudulent financial reporting.
- ^h The competence and experience of personnel assigned to process data or make decisions that affect the audit area.
- ⁱ The extent of judgment involved in determining the account balances for the audit area.
- ^j The size and volume of individual items comprising the account balances or transaction classes for the audit area.
- ^k The complexity of calculations affecting the audit area.

Reporting Entity: _____ Financial Statement Date: _____

		BASIC PROCEDURES		
		For many audit programs, the electronic files include audit procedures plus "practical considerations" to assist in performing those procedures. The practical considerations are always visible on the computer, but the auditor can choose whether or not to print them with the audit program steps.		
		Accounts Payable		
E/O, C, [R/O], V, A/CL, [CO]		1. Compare the balances in trade accounts payable with those of prior years. Investigate any unusual fluctuations, considering known changes in client activities.		
E/O, C, R/O, A/CL	^S	2. Obtain a listing of trade accounts payable as of the financial statement date. Reconcile the balance to the general ledger.		
		a. Investigate any unusual items.		
		b. Scan the listing for related-party accounts payable. Determine that appropriate financial-statement disclosures are made.		
C, A/CL, CO	^S	3. With respect to unrecorded liabilities, perform the following:		
		a. Inquire of responsible client personnel about:		
		(1) Procedures for processing invoices and the consistency of such procedures with those of prior years.		
		(2) Their knowledge of additional sources of unprocessed invoices, unrecorded commitments, or contingent liabilities. (See Form AD-5B for additional procedures to detect commitments and contingent liabilities.)		
		b. Trace receiving cutoff information to the accounting records, noting whether the liability is recorded in the proper accounting period.		
		Accruals and Other Liabilities		

GCAS SAM 2008

Basic Audit Program for Accounts Payable

I-1B

Assertions		Audit Procedures for Consideration	Performed by & Date, or N/A	Document Index
E/O, C, [R/O], A/CL	S	4. Compare the balances in accrued liabilities with those of prior years. Investigate any unusual fluctuations, considering known changes in client activities.		
[E/O], C, [R/O], V, A/CL, [CO]	S	5. Scan the working trial balance and determine those accrual or other liability accounts for which additional testing should be performed.		
		a. Determine the basis and method of accrual.		
		b. Test the reasonableness of the accrual by performing a predictive test of the amount.		
		c. Consider whether immaterial balances are reasonable and whether any needed accruals are missing.		
C, A/CL, [CO]	S	6. Scan the expense accounts in the working trial balance and compare their balances to prior-year balances. Investigate unusual fluctuations (that is, variations different from what would be expected, considering known changes in client operations or economic conditions) or the absence of accrued expense items that existed in the prior period that may indicate an unrecorded accrual. (This work should be performed in connection with the audit of expenses on Form TTX-1B.)		
		7. Consider whether the entity is liable for taxes related to the following and, if so, whether they are properly reported:		
		a. Payroll taxes, sales or VAT taxes, or property taxes.		
		b. Unrelated business income tax.		
		c. Activities that may jeopardize the organization's charitable or tax-exempt status.		
		d. Also complete Form CH-3 (Tax-related Considerations) to determine whether all required tax and information returns have been filed on a timely basis.		

		8. If the nonprofit organization is subject to unrelated business income tax, obtain or prepare an analysis of tax-related accounts. Perform the following procedures:		
		a. Scan the accounts and compare opening balances to the prior year's audit documentation.		
		b. Investigate any unexpected results, considering known changes in the nonprofit organization's activities.		
A/CL	S	9. Accumulate or summarize in the audit documentation the information needed for any required financial statement disclosures.		
		Concluding Audit Steps		
*	S	10. Consider the need to apply one or more additional procedures. The decision to apply additional procedures should be based on (a) your risk assessment documented at Form PN-11, (b) a consideration of whether information obtained or misstatements detected by performing audit procedures or from other sources during the audit alter your judgment about the assessed risk of material misstatement (whether caused by error or fraud), and (c) an evaluation of whether the procedures performed have provided sufficient assurance. If risks or other conditions are identified that require an additional audit response, ensure that those risks or conditions and your response are documented.		
*	S	11. Consider whether the results of audit procedures indicate internal control related matters that are required to be communicated to management and others. If so, add to Form I-2 for the communication of internal control related matters.		
		CONCLUSION		
		We have performed procedures and obtained audit evidence sufficient to provide reasonable assurance about accounts payable and other liabilities (to support our opinion on the financial statements taken as a whole), and the results of these procedures are adequately documented. (If you are unable to conclude, prepare a memo documenting your reason.) []		

Assessing Audit Risk

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Questions?