Course: Financial Audit

Lecture 6: Audit Risk Model

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Introduction

Overview of Lecture 5

Audit Reporting Standards

- The audit reporting standards set by the Public Company Accounting Oversight Board (PCAOB) and the American Institute of Certified Public Accountants (AICPA) emphasize the principles of risk-based auditing and materiality.
- These frameworks guide auditors in issuing audit opinions that address the potential risks of material misstatements.

Assurance Concept

- The concept of "reasonable assurance" reflects the highest level of certainty that auditors can provide without claiming absolute accuracy.
- While auditors employ rigorous procedures to gather sufficient and appropriate evidence, they recognize that some risks are unavoidable due to limitations in sampling and the nature of audit evidence.

Material Misstatement

- The term "material misstatement" pertains to financial statement inaccuracies that could influence the economic decisions of users.
- Materiality is a threshold concept that auditors use to differentiate between significant errors that may affect the overall integrity of financial reports and minor discrepancies.
- The determination of what constitutes a material misstatement involves both quantitative and qualitative considerations, including the nature of the item, the circumstances surrounding the misstatement, and the potential impact on stakeholders' decision-making.

Risk Assessment

- Auditors undertake risk assessments during the planning phase to allocate resources effectively and design procedures that address identified risk areas.
- The risk assessment process involves evaluating the susceptibility of financial statements to misstatements, considering factors such as economic conditions, industry-specific risks, and the complexity of the entity's operations.

Evaluating Risk Steps

- The risk evaluation process integrates both inherent risk and control risk.
- Auditors assess these risks using various methods, including analytical procedures, discussions with management, and examining the entity's past financial performance.
- The outcomes of this evaluation guide the design of audit tests to target areas of higher risk.

Auditors’ Understanding

- A comprehensive understanding of the entity’s business model, regulatory environment, and internal control systems is essential for assessing the risk of material misstatement.
- Auditors achieve this understanding through a combination of fieldwork, review of documentation, and discussions with personnel. This foundational knowledge helps auditors identify key risk areas and determine the audit approach.

Role of Professional Judgment

- Professional judgment is critical in the audit process, as it allows auditors to make informed decisions based on evidence and circumstances.
- The exercise of judgment involves evaluating the sufficiency of evidence, considering the reliability of management representations, and determining the impact of uncertainties.
- Given the subjective nature of many audit tasks, auditors must apply their expertise and skepticism to assess risks effectively

Material Misstatement Risk

- Misstatement risks can be assessed at both the financial statement and assertion levels.
- At the financial statement level, risks pertain to factors that affect the overall reliability of the financial reports. At the assertion level, risks are linked to specific claims made by management regarding account balances, transactions, and disclosures.

Audit Procedures

- Auditors customize their procedures based on the assessed risks to ensure that sufficient audit evidence is obtained.
- This involves applying various techniques, such as detailed substantive testing, walkthroughs, and control testing, to gather evidence that supports the audit opinion.

Inherent and Control Risks

- Inherent risk is a function of the entity's environment, complexity of transactions, and industry characteristics, while control risk is influenced by the design and implementation of internal controls.
- Auditors assess these risks separately but also consider how they interact, as a higher inherent risk may necessitate more robust internal controls to mitigate potential misstatements.

Understanding Entity Risks

- Understanding risks involves employing methods like interviews, reviewing historical data, and observing internal processes.
- Auditors also consider the broader industry context and economic trends that may impact the entity's operations.

Combining Information

- While individual risk assessment techniques yield valuable insights, they must be considered collectively to provide a holistic risk profile.
- The integration of information from multiple sources allows auditors to develop a comprehensive understanding of the entity’s risk environment and plan procedures accordingly.

Entity Management Interactions

- Engaging with various levels of management provides insights into internal controls, financial policies, and risk management practices.
- These interactions help auditors understand management's approach to addressing risks and implementing controls, which informs the assessment of the control environment.

Inquiries

- Discussions with governance bodies, such as the board of directors or audit committee, offer strategic insights into the organization’s risk management framework.
- Similarly, internal audit departments provide information on past audits, ongoing monitoring activities, and identified control deficiencies, which assist in refining the risk assessment.

Analytical Procedures

- Preliminary analytical procedures involve comparing current financial data with historical trends, industry benchmarks, and budget expectations to identify anomalies or unexpected variations.
- These procedures aid in pinpointing areas that warrant further investigation and inform the risk assessment process.

Observation and Inspection

- Observational and inspection techniques allow auditors to corroborate information obtained through other procedures.
- For example, inspecting inventory records or observing physical asset counts can confirm the existence and condition of assets, providing additional evidence for evaluating the accuracy of financial statements.

Engagement Team Discussions

- Team discussions ensure that all members are aware of potential risks and can contribute diverse perspectives.
- This collaborative approach leverages the expertise of the audit team, enhancing the identification of areas susceptible to misstatements, including potential fraud risks.

Pre-Engagement Insights

- Prior audit experience provides a baseline for understanding recurring risks and identifying changes in the entity's operations.
- This knowledge allows auditors to anticipate potential problem areas and adjust their audit strategy accordingly.

External Information Sources

- External information, such as economic forecasts, regulatory updates, and industry analyses, can significantly influence the auditor's risk assessment.
- Staying attuned to these factors helps auditors identify emerging risks that could affect the accuracy of financial statements.

Fraud Detection Challenges

- Detecting fraud is particularly challenging due to its often concealed nature, intentional manipulation, and collusion.
- Auditors must remain vigilant for red flags, such as unusual transactions or management behavior, and use specialized procedures, like forensic techniques or data analytics, to uncover potential fraudulent activities.

Professional Skepticism

- Auditing standards emphasize that audits should be approached and conducted with professional skepticism throughout all phases.
- The foundation of professional skepticism involves maintaining a questioning mindset and critically evaluating the evidence collected during the audit process.

Procedures for Assessing

- To evaluate the risk of material misstatement arising from fraudulent activities, auditing standards provide specific procedures auditors should implement to obtain relevant insights from management.
- Auditors should gather information on the frequency and extent of these assessments, as well as the processes in place for identifying, addressing, and monitoring fraud risks.

Risk Assessment

- Auditors assess the risk of material misstatement due to fraud at both the financial statement level and the assertion level, which pertains to specific classes of transactions, account balances, and related disclosures.
- Given the history of fraudulent financial reporting cases often involving revenue recognition, auditing standards require auditors to presume there is a risk of fraud in this area.

Indentifying Significant Risks

- Auditors must determine whether the risks identified during the audit process constitute significant risks, warranting special attention.
- A significant risk is defined as an assessed risk of material misstatement that, based on the auditor's professional judgment, demands special audit consideration.
- The identification of these risks is central to effective audit planning, requiring auditors to understand the entity's internal controls relevant to these risks and to perform substantive testing where necessary.

Significant Risk Characteristics

- Significant risks are commonly associated with nonroutine transactions, which may be infrequent, complex, or unusual due to size or nature.
- For instance, if a retail company that typically sells through its own stores decides to sell a large volume of inventory from a distribution center to a competitor, the terms of such a transaction may include complex negotiations, buy-back provisions, or warranties that elevate the risk of material misstatement in revenue recognition or receivable collections

Risks Involving Estimates & Judgments

- Another category of significant risks involves transactions or balances that require considerable judgment, especially in the context of accounting estimates with substantial measurement uncertainty.
- Transactions based on complex estimates, such as fair value accounting for significant hedging activities, are often treated as significant risks because of the subjectivity and complexity involved.

Detecting Frauds Challenges

- The nature of fraudulent activities, which often involve deliberate concealment or manipulation, makes the detection of fraud particularly challenging.
- When auditors identify a potential risk of material misstatement due to fraud, auditing standards categorize such risks as significant, prompting specific responses to address these risks.

Audit Risk Model

- To manage audit risks effectively, auditors employ the audit risk model to decide on the quantity and type of evidence needed to satisfy each audit objective. The model is represented by the equation:

$$PDR = \frac{AAR}{IR\ X\ CR}$$

- Where:

  PDR: Planned Detection Risk

  AAR: Acceptable Audit Risk

  IR: Inherent Risk

  CR: Control Risk

Understanding Inherent & Control Risks

- Inherent risk refers to the susceptibility of a financial statement assertion to material misstatement before considering the effectiveness of any internal controls
- This assessment does not take into account internal controls, which are considered separately as part of control risk.
- The audit risk model emphasizes the relationship between inherent risk, control risk, and planned detection risk.
- Higher inherent or control risks imply a need for more extensive substantive testing, whereas effective internal controls may reduce the need for extensive audit procedures.

Combining Inherent & Control Risks

- The combined effect of inherent and control risks, referred to as the risk of material misstatement, guides the auditor's approach in designing audit procedures.
- Auditors may evaluate these risks separately or as a single combined assessment. As control risk increases, planned detection risk decreases, necessitating more thorough evidence collection.
- Conversely, if internal controls are deemed effective, planned detection risk can be increased, allowing auditors to reduce the amount of substantive testing.

Practical Implications

- In practice, when auditors assess high inherent risks in particular audit areas, they often assign more experienced staff to these areas and conduct more rigorous reviews of the audit procedures performed
- This thorough consideration of audit risks ensures that auditors design their procedures to target areas with higher risks, thus optimizing the efficiency and effectiveness of the audit.

Control & Audit Risk

- Before auditors can reduce the assessment of control risk below 100%, they must first gain a comprehensive understanding of the organization’s internal control systems.
- This process includes evaluating the design and implementation of these controls to assess how effectively they should function in preventing or detecting material misstatements.
- Additionally, auditors perform testing on these controls to confirm their operational effectiveness. Such a thorough understanding is mandatory for all audits, whereas the testing phase is only necessary when control risk is assessed at less than its maximum level.

Role of Internal Control

- For auditors of large public companies, there is a significant reliance on internal controls due to the requirements under the Sarbanes-Oxley Act, which mandates the evaluation of internal control effectiveness over financial reporting.
- Conversely, for other entities, auditors may choose to rely on effective controls, particularly when the entity utilizes automated processes for day-to-day transactions.

Acceptable Audit Risk

- Acceptable audit risk (AAR) represents the degree of risk that the auditor is willing to accept that the financial statements may contain material misstatements even after the issuance of an unmodified opinion.
- This concept recognizes that absolute certainty is neither feasible nor economically practical. Instead, auditors aim to achieve a reasonable level of assurance that is acceptable for the circumstances.

Balancing Audit Risk

- In applying the audit risk model, there is a direct correlation between AAR and planned detection risk (PDR), and an inverse relationship between AAR and the amount of audit evidence required.
- If an auditor reduces AAR, this necessitates a corresponding reduction in PDR, leading to an increase in the amount and quality of evidence that must be collected.

Risk Factors

- In assessing the components of the audit risk model, auditors must consider different elements that affect each risk factor.
- While AAR is based on the auditor’s professional judgment concerning client-related factors, IR and CR are evaluated based on the conditions present within the client organization.

Engagement Risk

- Auditors determine the appropriate level of AAR during the planning phase by first evaluating engagement risk, which reflects the potential for harm to the auditor or audit firm after the issuance of the audit report, irrespective of the audit quality.
- This may occur, for example, if the client experiences financial distress post-audit, resulting in increased legal exposure for the audit firm

Factors Influencing Engagement Risk

- Several factors influence engagement risk and subsequently impact AAR. These include:

1. External User Reliance on Financial Statements: The higher the degree of reliance on the financial statements by external parties, the lower the AAR should be set. Indicators of high reliance include the size of the organization, the distribution of its ownership, and the nature of its liabilities.
2. Likelihood of Client Financial Difficulties: The probability of a client experiencing financial difficulties can affect engagement risk.
3. Management Integrity: Clients with questionable management integrity pose a higher risk. Signs of low integrity may include past legal issues, frequent disputes with regulatory bodies, or inconsistent turnover in financial management.

Evaluation of AAR

- Auditors classify acceptable audit risk into categories such as high, medium, or low, with a lower AAR indicating a higher-risk client that necessitates more extensive audit work.
- As the audit progresses, information obtained may lead to revisions in the original risk assessments.

Incorporating Inherent Risk

- Inherent risk is a fundamental consideration that informs auditors where material misstatements are more likely to occur within the financial statements.
- This prediction guides the extent of audit procedures, the level of staffing expertise required, and the necessary documentation review.
- By identifying areas of higher inherent risk, such as estimates involving complex financial instruments, auditors can strategically allocate resources to ensure a thorough audit.

Assessing Audit Risk

- When assessing inherent risk, several key considerations should be taken into account, including:

1. The Nature of the Client's Business: The industry and operational characteristics of a client affect inherent risk.
2. Outcomes of Previous Audits: The presence of errors in past audits often indicates systemic issues that may persist if not adequately addressed.
3. Initial vs. Repeat Engagements: New audit engagements generally involve higher inherent risks due to limited familiarity with the client’s operations and financial systems.
4. Related Party Transactions: Transactions involving related parties, such as between a parent company and subsidiaries or management, are inherently riskier.

Assessing Audit Risk

- When assessing inherent risk, several key considerations should be taken into account, including:

5. Complex or Unusual Transactions: Nonroutine transactions and those involving intricate agreements are more prone to recording errors due to the client's limited experience in handling them.
6. Judgment and Estimation in Financial Reporting: Accounts requiring subjective estimates, like valuation of certain investments or provisions for warranties, present higher inherent risks due to the judgment involved.
7. Characteristics of the Population: The composition of account balances may also affect risk assessments.
8. Fraud Risk Indicators: The difficulty in separating fraud-related risks into categories like inherent, control, or acceptable audit risk complicates the evaluation process.

Impact of Business Nature

- Inherent risk is influenced by the characteristics of the client's industry.
- The inherent risk profile will thus vary across financial statement items, such as inventory, receivables, and investments, based on the nature of the business.
- In contrast, accounts like cash or long-term liabilities are less likely to be influenced by industry-specific factors. An auditor’s understanding of the client’s industry and business model helps shape the risk assessment and audit approach.

Considering Prior Audit Results

- Recurring misstatements from previous audits are likely to persist if underlying issues remain unaddressed.
- If past audits revealed significant inaccuracies in areas like inventory valuation, an elevated inherent risk assessment would be appropriate for the current audit. Conversely, if no material misstatements have been detected over several years, auditors may reduce the inherent risk assessment, provided there have been no major changes in circumstances.

Initial vs Repeat Engagements

- The level of inherent risk is typically higher during an initial audit due to the auditor’s lack of prior experience with the client.
- In subsequent audits, as the auditor gains more knowledge about the client's internal controls and financial practices, the perceived inherent risk can be reassessed and potentially reduced.

Related Party Transactions

- Transactions involving related parties, such as between parent and subsidiary entities, do not meet the "arm's length" criteria set by accounting standards.
- As a result, there is a greater chance of misstatements or incomplete disclosures, leading to an increased inherent risk in these areas.

Complex/Nonroutine Transactions Risk

- Transactions that deviate from the client's regular business operations often involve higher levels of risk due to the unfamiliarity with how to properly account for them

Judgment-Driven Accounts

- Account balances that require significant judgment or estimation pose a higher inherent risk due to the potential for bias or error.
- The need for substantial judgment increases the likelihood of misstatements, necessitating a higher inherent risk assessment.

Population Characteristics

- The auditor's expectations about potential misstatements are also shaped by the composition of the account balances being reviewed.
- Similarly, transactions with affiliated entities, amounts due from executives, or unusual payment practices warrant a higher level of scrutiny.

Integrating Fraud Risk

- While fraud risk factors can intersect with acceptable audit risk, inherent risk, and control risk, they also encompass broader considerations.
- For instance, management's ethical standards and motivation to manipulate financial results influence the overall risk environment. Therefore, risk factors associated with management behavior and company culture play a crucial role in determining the risk levels across various audit categories.

Responding to Fraud Risks

- Auditors must assess fraud risks at different levels, such as the overall audit, specific cycles, accounts, or individual audit objectives
- In contrast, the risk of theft may be confined to the inventory account. In response to these risks, the auditor should adjust audit procedures, including reassessing acceptable audit risk, inherent risk, and control risk.

Evaluating Inherent Risk

- The auditor's evaluation of inherent risk must consider how factors impact specific audit objectives.
- Some considerations, such as whether the engagement is initial or repeat, may affect multiple areas, while others, like complex transactions, could impact particular accounts. Although no formal standards exist for assessing inherent risk, auditors generally adopt a conservative approach.

Modifying Audit Approach

- Auditors primarily address risks by adjusting the scope of testing and altering the types of audit procedures employed, which may include introducing elements of unpredictability into the audit process. In addition to modifying the audit evidence collected, there are two additional strategies that auditors can adopt to adapt the audit in response to identified risks:
  - Utilization of More Experienced Staff
  - Enhanced Review Procedures

Segment-Specific Risk Assessments

- In the auditing process, the evaluation of material misstatement risk, control risk, and inherent risk is conducted for each relevant audit objective within every segment of the audit. These assessments can differ significantly within the same audit across various cycles, accounts, and objectives.
- Consequently, the control risk associated with cash existence would typically be lower than that associated with the valuation of fixed assets.
- Acceptable audit risk is generally determined by the auditor during the planning phase and is typically consistent across major cycles and accounts. Auditors often adopt the same acceptable audit risk for all segments because the elements influencing acceptable audit risk pertain to the audit as a whole rather than individual accounts.

Segment-Specific Risk Assessments

- However, there may be instances where a lower acceptable audit risk is warranted for specific accounts compared to others. This decision underscores the necessity for auditors to remain adaptable and responsive to the contextual factors affecting individual accounts.

- Some auditors prefer to maintain a uniform acceptable audit risk across all segments, based on the belief that financial statement users should attain a consistent level of assurance for each component of the financial statements.

- Similar to control risk and inherent risk, planned detection risk and the requisite audit evidence will fluctuate from one cycle to another, from account to account, or between different audit objectives. This variability should not come as a surprise; the unique circumstances of each audit engagement will dictate the extent and nature of the evidence needed.

Segment-Specific Risk Assessments

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Challenges

- A significant challenge inherent in utilizing the audit risk model is the complexity involved in quantifying its various components.
- Moreover, quantifying the amount of evidence that corresponds with a specific level of planned detection risk poses a similar difficulty. An effective audit program designed to lower detection risk to an acceptable level typically consists of a series of audit procedures, each employing diverse types of evidence tailored to different audit objectives.
- Auditors are expected to use their professional judgment to ascertain if additional or varied types of evidence are necessary to mitigate a low planned detection risk compared to a medium or high level.

Audit Risk Model as Planning Tool

- The audit risk model serves primarily as a framework for planning the audit process, which inherently limits its utility when it comes to evaluating the results of the audit.
- When auditors gather the planned evidence and subsequently determine that their initial risk assessments were sound or even more favorable than previously anticipated, they can confidently conclude that they have collected a sufficient amount of appropriate evidence to meet the audit objectives relevant to specific accounts or cycles.

Audit Risk Model as Planning Tool

- Nevertheless, auditors must exercise considerable caution if, upon analyzing the collected evidence, they find that their initial evaluations of control risk or inherent risk were understated or that their assessment of acceptable audit risk was exaggerated. In such instances, auditors should adopt a two-step procedure to rectify the situation:
  - The auditor must adjust the original risk assessment to reflect the more accurate understanding of the circumstances. It is deemed a breach of professional diligence to maintain the original assessment if the auditor is aware that it no longer holds true.
  - Following the adjustment of the risk assessment, the auditor should assess how this revision impacts the requirements for evidence without relying solely on the audit risk model.

Materiality and Risk Interrelations

- Materiality and risk are intrinsically linked concepts in auditing. While risk reflects uncertainty, materiality pertains to the significance of financial statement amounts. Both factors must be analyzed together to understand the auditor’s approach to evidence collection.
- Finally, auditors must carefully evaluate the sufficiency and appropriateness of the evidence collected during the audit. Evidence gathering should be tailored to address specific risks identified throughout the audit process, ensuring that the auditor can draw reliable conclusions regarding the financial statements' fairness and compliance with applicable standards.

Conclusion

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Closing

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