

Course: Financial Audit

Lecture 11: Auditor's Response to Assessed Risk

Lecturer: Dimaz Ramananda

Audit Risk

- Auditing standards mandate that auditors gain a comprehensive understanding of the entity being audited, including its internal control systems, to accurately evaluate the risk of material misstatements within the financial statements.
- Auditors accept a degree of inherent uncertainty in their work, acknowledging, for instance, the indeterminate nature of the sufficiency of evidence, the potential weaknesses in the client's internal controls, and the possibility of undetected misstatements even after concluding the audit. Proficient auditors are aware of these risks and adopt strategies to manage them effectively.

Audit Risk

- Risk of material misstatement, this term refers to the likelihood that errors or fraudulent actions have resulted in significant inaccuracies in the financial statements before any audit work has commenced
- Auditing standards require that auditors assess the risk of material misstatement on two levels: the overall financial statement level and the assertion level for specific transactions, events, account balances, and disclosures. This dual-layered risk assessment guides the auditor's planning for targeted and effective audit procedures aligned with the risk profile identified.

Audit Risk

- Risks at the overall financial statement level are those that affect the integrity of the entire financial report and could influence multiple accounts and transaction classes.
- Likewise, weak or outdated accounting systems may exacerbate these risks. Broader economic trends, such as an industry downturn or economic crisis, can further elevate these overarching risks, as such conditions may pressure financial reporting or introduce significant challenges for the business.

Audit Risk

- Auditors are required to evaluate material misstatement risks across all assertions linked to transaction classes and account balances. This risk assessment is essential for determining the nature, timing, and scope of subsequent audit procedures.
- Control risk, on the other hand, represents the possibility that a misstatement might not be timely prevented, detected, or corrected by the client's internal controls. Higher inherent risk may be present in complex accounts or estimates requiring judgment, while control risk may increase if verification mechanisms or independent reviews of complex calculations or estimates are absent.

Audit Risk

- To obtain a complete understanding of the entity, its environment, and its internal controls, auditors engage in a range of risk assessment activities. These include:
 - Inquiries with Management and Entity Personnel
 - Analytical Procedures
 - Observation and Inspection
 - Engagement Team Discussions
 - Other Risk Assessment Procedures

Audit Risk

- While these initial risk assessment steps don't provide conclusive evidence for forming an audit opinion, they are crucial for evaluating misstatement risks and shaping the audit plan.
- Auditors may gain unique insights through conversations with individuals across various roles, as those outside of financial reporting often possess perspectives that reveal critical risk factors not readily apparent from a single standpoint.

Audit Risk

- Discussions with the board of directors or audit committee offer an overarching view of the business's competitive environment, strategic risks, and governance practices.
- The AICPA suggests that inquiries with governance bodies can yield valuable insights, while PCAOB standards require such interactions to identify material misstatement risks. Internal audit personnel are another invaluable resource, as they often understand comprehensive business risks and control deficiencies, particularly those impacting financial reporting, operational integrity, and regulatory compliance.

Audit Risk

- Auditors are expected to apply preliminary analytical procedures during the planning phase to gain a broader understanding of the entity's risk landscape.
- Incorporating both financial and nonfinancial data, these analyses are typically high-level and offer an initial perspective rather than definitive conclusions about potential misstatements. The insights gained through analytical procedures help auditors triangulate with other risk assessment activities for a more robust audit plan.

Audit Risk

- Observing an entity's business processes, such as production workflows or logistical operations, allows auditors to gain an operational understanding beyond financial statements alone.
- Site visits and process observations offer practical insights into how internal controls are implemented, while inspecting key documents, like strategic plans or organizational charts, further informs the auditor's view of business structure and control environment.
- Additionally, observing employees perform processes related to financial reporting enables auditors to verify control design and effectiveness.

Audit Risk

- Auditing standards mandate that the engagement partner and key members of the audit team discuss the likelihood of the client's financial statements containing material misstatements. Such discussions offer experienced team members, including the engagement partner, a platform to share insights on the client's environment and the effectiveness of its internal controls. This exchange of ideas, or "brainstorming," should address the various business risks and areas within the financial statements that could be vulnerable to material misstatement, whether arising from error or fraud.
- Ultimately, the engagement partner must decide which matters are essential to communicate to other team members not present in the discussion. For complex engagements, a communication plan is advisable to ensure that critical insights are effectively disseminated across the team.

Audit Risk

- Information from the client acceptance or continuation process, including discussions with previous auditors and results from background checks, provides the auditor with early indicators of potential risks for material misstatement.
- Additionally, information from engagements in other areas, such as tax-related services, can reveal unique transactions that may elevate material misstatement risk. Information from external sources like analyst reports, industry publications, or regulatory updates also deepens the auditor's understanding of the client's environment.

Audit Risk

- Although risk assessment procedures target misstatements due to both error and fraud, detecting fraud-related misstatements is often more challenging. Fraud schemes can be complex, sometimes involving fabricated documentation or undisclosed transactions.
- Perpetrators might also misrepresent facts or collaborate with others to conceal fraudulent activity, complicating detection. Therefore, auditors must approach the audit with professional skepticism, maintaining a mindset that allows for the possibility of material misstatements despite management's reputation for integrity.

Audit Risk

- Auditing standards outline specific procedures to help auditors assess fraud risk.
- Auditors should also seek information from management or other personnel on any known fraud cases, suspected or actual, and confirm whether management has relayed these risks to those responsible for governance.
- Fraud risk assessment is conducted at both the financial statement level and at the level of specific assertions in transactions and account balances.

Audit Risk

- During the assessment of misstatement risks, whether due to fraud or error, auditors must determine if any identified risks require special consideration. Such risks, referred to as "significant risks," typically involve transactions or events that are unusual in nature or size.
- Nonroutine transactions, for example, can heighten misstatement risks due to factors such as management intervention, reliance on manual processes, or complex calculations. These transactions might include a retailer selling a substantial inventory block to a competitor or engaging in negotiations that include buy-back clauses and warranties.

Audit Risk

- Significant risks also often relate to areas requiring substantial judgment, especially in the case of accounting estimates that involve considerable uncertainty. A client initiating a new type of financial transaction, such as a hedging strategy, may pose a significant risk due to management's limited experience in its accounting treatment.
- Given the inherent difficulty of uncovering fraudulent activity, auditors are required to address potential fraud-related risks as significant risks. Fraud typically involves intentional concealment, requiring auditors to implement heightened procedures.

Audit Risk

- Predicting financial failure in advance is challenging for auditors; however, certain indicators can signal an increased risk of financial difficulties:
 - Liquidity position
 - Historical profits
 - Growth financing methods
 - Business nature
 - Management competence

Audit Risk

- When a client has questionable integrity, auditors may assess a lower acceptable audit risk. Clients with integrity issues often engage in practices that cause conflicts with stakeholders, regulatory bodies, or customers, which can affect public perception of audit quality and lead to legal disputes.
- Acceptable audit risk is typically rated as high, medium, or low. A lower acceptable audit risk signifies a “riskier” client, warranting more extensive audit evidence, experienced personnel, and thorough documentation reviews.
- The inclusion of inherent risk in the audit risk model requires auditors to predict where misstatements are more or less likely within financial statement sections.

Audit Risk

- Auditors evaluate several key factors when assessing inherent risk, including:
 - Client's Business Nature
 - Previous Audit Outcomes
 - Initial vs. Repeat Engagement
 - Related Parties
 - Complex or Unusual Transactions
 - Judgment Required for Accurate Recording
 - Population Composition
 - Fraudulent Financial Reporting Factors
 - Asset Misappropriation Factors

Audit Risk

- Prior year misstatements often recur in the current year, as some misstatements are systemic, and organizations may be slow to address them. Ignoring past audit results can be seen as negligence.
- Auditors gain insights into misstatement likelihood over successive audits, generally assigning a higher inherent risk in initial audits, which they may lower in repeat audits when no material misstatements have been detected.
- Related party transactions are inherently risky due to their lack of independence. This often increases the chance of misstatement or inadequate disclosure, thereby raising inherent risk.

Audit Risk

- Nonroutine or unusual transactions, often involving complex contracts, are more prone to errors since the client may lack experience with these types of transactions. Examples include significant property purchases, fire losses, complex investments, and restructuring charges.
- Certain account balances rely heavily on management estimates and judgment.
- The composition of the total population also impacts the likelihood of material misstatements. Auditors often set a higher inherent risk for valuation in accounts with overdue receivables compared to those with current balances.
- It can be challenging to distinguish between acceptable audit risk, inherent risk, and control risk regarding fraud risk factors.

Audit Risk

- According to auditing standards, it's more critical for auditors to assess and respond to risks than to categorize them by type. Therefore, many audit firms go beyond simply assessing the risk of material misstatements by implementing extra procedures specifically for fraud risk assessment.
- Fraud risk should be evaluated for the entire audit and within specific cycles, accounts, and objectives. For both fraudulent financial reporting and asset misappropriation risks, auditors focus on high-risk areas and adjust audit procedures or strategies accordingly.
- Auditors assess inherent risk factors to evaluate the risk of material misstatements at the objective level for cycles, balances, and disclosures. Some factors, like whether the engagement is initial or repeat, affect multiple cycles, while others, like nonroutine transactions, impact specific accounts or objectives.

Audit Risk

- Auditors respond to assessed risks by adjusting both the depth of testing and the types of procedures used, incorporating unpredictability to enhance the audit's rigor. Beyond modifying the nature and amount of audit evidence, auditors have two primary approaches to address elevated risk levels:
 - Assigning more experienced personnel
 - Enhanced engagement reviews

Audit Risk

- Acceptable Audit Risk is generally determined during the planning phase and is maintained consistently for major cycles and accounts. Auditors often apply the same acceptable audit risk across all segments because factors affecting it typically relate to the entire audit rather than individual accounts.
- Different auditors apply acceptable audit risk across segments based on varied perspectives. Some believe that financial statement users should have the same assurance level across all statement segments, while others contend that users may focus more on specific accounts.

Audit Risk

- Just as control and inherent risks vary, **Planned Detection Risk** and the necessary audit evidence differ across audit cycles, accounts, and objectives. This variation is unsurprising, as each engagement's specific circumstances dictate the required evidence.
- Conversely, accounts receivable may require minimal testing on the same engagement if there are strong internal controls, rapid collection, excellent client-customer relationships, and consistent audit results from prior years.
- Though auditors frequently assess inherent and control risks for each balance-related objective, they typically do not allocate materiality across these objectives. While it is generally straightforward to associate most risks with specific objectives, allocating materiality to individual objectives within an account is more complex.

Audit Risk

- A primary limitation of the audit risk model is the inherent difficulty in quantifying its components. Despite careful planning, assessments of acceptable audit risk, inherent risk, control risk, and therefore planned detection risk remain subjective estimates rather than exact figures.
- Similarly, calculating the precise amount of evidence required to meet a planned detection risk level poses difficulties. An audit program designed to reduce detection risk generally comprises a combination of audit procedures, each type gathering different forms of evidence for varying objectives.

Audit Risk

- Since the Audit Risk Model primarily serves as a planning tool, its effectiveness for evaluating results is limited.
- When auditors determine, based on accumulated evidence, that their initial assessment of control risk or inherent risk was too low, or that acceptable audit risk was set too high, it's crucial to proceed with caution to maintain audit quality. In these cases, auditors should take a structured, two-step approach:
 - Step 1: Revise the initial risk assessment
 - Step 2: Adjust evidence requirements independently from audit risk model

Audit Risk

- Fraudulent financial reporting involves intentionally misstating or omitting amounts or disclosures to deceive financial statement users. Typically, these misstatements relate to numerical amounts rather than disclosures.
- While fraudulent financial reporting often aims to overstate income some companies also understate income deliberately. This process, known as income smoothing.
- Misappropriation of assets involves theft within a company, often involving employees. Even if the amounts involved aren't material to financial statements, asset theft can harm a company's reputation and become more significant if unchecked. Misappropriation generally refers to internal theft by employees

Audit Risk

- Auditing standards identify three factors (known as the fraud triangle) that must be present for fraud to occur:
 - Incentives/Pressures
 - Opportunities
 - Attitudes/Rationalization

Audit Risk

- Auditing standards require auditors to assess fraud risk and provide guidance to support this assessment. Auditors must exercise professional skepticism, assuming a questioning mindset to uncover fraud risk factors and respond accordingly.
- Auditing standards also emphasize that auditors should consider a client's fraud susceptibility without assuming the honesty or integrity of management. In planning an audit, the engagement team must discuss the importance of maintaining skepticism and critically evaluating evidence throughout the process.

Audit Risk

- Auditing standards require that the audit team, which includes the engagement partner and essential members of the audit team, participate in thorough discussions to gather insights and “brainstorm” ideas that facilitate a deeper understanding of the following key areas:
 - First, they examine how and where they believe the entity’s financial statements, including disclosures, might be vulnerable to material misstatements due to fraud.
 - The team must also discuss potential ways in which management might perpetrate and conceal fraudulent financial reporting.
 - Moreover, they must consider the likelihood of misappropriation of the entity's assets.
 - Finally, they are required to deliberate on how the auditor can effectively respond to the identified susceptibilities to material misstatements due to fraud.

Audit Risk

- In addition to these team discussions, auditing standards mandate that auditors make specific inquiries regarding fraud for every audit. Engaging with management and other employees within the company provides these individuals with a valuable opportunity to disclose any relevant information that might not be communicated otherwise.
- The audit committee plays a critical role in overseeing management's approach to fraud risk assessment and response. Auditors must inquire with the audit committee or other governance bodies to gain insights into their views on fraud risks and whether they are aware of any fraud or suspected fraud.

Audit Risk

- In evaluating fraud risk factors, auditors assess indicators that could suggest incentives, opportunities, or rationalizations for fraud. The presence of these factors doesn't confirm fraud but does imply an increased likelihood. Auditors assess fraud risk at both the overall financial statement level and the assertion level, considering specific classes of transactions, account balances, and associated disclosures.
- Corporate governance and control measures are essential for minimizing fraud risk. Management holds responsibility for implementing corporate governance structures and control systems to deter fraud through a combination of preventative, deterrent, and detection-based measures.

Audit Risk

- To support organizations in developing comprehensive approaches to managing fraud risks, the Committee of Sponsoring Organizations (COSO) recently published the *Fraud Risk Management Guide*. This guide aligns with and supplements the *COSO Internal Control – Integrated Framework* by emphasizing principles for managing fraud risk. Additional guidance from the AICPA outlines three elements for preventing, deterring, and detecting fraud:
 1. A culture of honesty and strong ethics.
 2. Management's duty to evaluate fraud risks.
 3. Oversight by the audit committee.

Audit Risk

- Fostering a company culture based on core values is among the most effective methods to prevent and deter fraud. These values shape an environment where ethical behavior is encouraged and modeled, providing employees with a foundation for responsible decision-making.
- A supportive workplace fosters improved morale, which can reduce employees' inclination toward fraud. Employees should have access to internal guidance on decisions involving ethical or legal implications.

Audit Risk

- To effectively prevent fraud, well-run companies implement rigorous screening policies aimed at minimizing the risk of hiring or promoting individuals with questionable integrity.
- Fraud cannot occur without an apparent opportunity, real or perceived, for committing and concealing the act. This opportunity aspect underscores the crucial role of management, which bears the responsibility for proactively identifying and assessing fraud risks within the organization.
- The Association of Certified Fraud Examiners (ACFE) issued the *Report to the Nations on Occupational Fraud and Abuse*, which highlights the considerable impact that the presence of 18 commonly adopted internal controls has on reducing the median financial losses organizations experience across all types of fraud.

Audit Risk

- Management is also tasked with designing and implementing measures to reduce fraud risks by altering business practices and processes that could be susceptible to fraudulent activities.
- Internal audits play a critical role in monitoring these antifraud initiatives to ensure that fraud prevention, deterrence, and detection measures are effectively executed. The role of internal auditors in fraud oversight is twofold: they deter fraud by evaluating internal controls that reduce fraud risks, and they detect fraud by conducting audit procedures that could reveal fraudulent financial reporting or misappropriation of company assets.

Audit Risk

- The audit committee holds a primary responsibility in overseeing the organization's financial reporting and internal control systems. As part of this oversight, the committee must evaluate the risk of management overriding internal controls and take charge of supervising management's fraud risk assessment processes and antifraud controls.
- The oversight of the audit committee also acts as a deterrent to fraud by senior management. For instance, to discourage senior management from pressuring employees into participating in or concealing fraud, audit committee oversight might include:
 - Direct reporting of key findings by internal auditors to the audit committee,
 - Regular reporting by ethics officers regarding whistleblower complaints,
 - Other reports on unethical behavior or suspected fraud cases.

Audit Risk

- Given the audit committee's essential role in establishing a strong ethical tone and overseeing management actions, PCAOB auditing standards require auditors of public companies to evaluate the board and audit committee's effectiveness as part of the assessment of the operating efficiency of internal control over financial reporting.
- Upon identifying fraud-related risks that could lead to material misstatements, auditors are required by auditing standards to formulate responses at three levels: overall responses, responses at the assertion level, and responses that address management override.

Audit Risk

- Auditors have several options for responding to elevated fraud risk levels.
- Auditors must also carefully consider the accounting principles management adopts, particularly principles involving subjective measurement and complex transactions.
- Fraud perpetrators are often familiar with standard audit procedures, which is why auditing standards mandate that auditors integrate unpredictability into their audit approach.
- When the auditor identifies fraud risk at the assertion level, they design specific audit procedures to address the unique risks associated with the account and the nature of the fraud risk involved.

Audit Risk

- The risk of management override of controls is a persistent concern in nearly all audits. Due to management's unique position, they can override controls that typically function effectively, enabling fraudulent activities. As a result, auditors are mandated to perform procedures to address this risk in every audit.
- Auditing standards place emphasis on understanding the underlying business rationale for significant, unusual transactions that may fall outside the company's regular course of business.

Audit Risk

- The auditor's evaluation of the risk of material misstatement due to fraud should be a continuous process throughout the audit, aligning closely with other risk assessment procedures. Auditors should be vigilant for the following indicators during the audit:
 - Discrepancies within accounting records,
 - Conflicting or missing audit evidence,
 - Unusual or problematic relationships between the auditor and management,
 - Analytical procedures in the substantive or final review stages that reveal previously unrecognized fraud risks,
 - Vague, implausible, or inconsistent responses to inquiries.

Audit Risk

- Depending on the client's industry, certain accounts are especially vulnerable to manipulation or theft. Specific high-risk accounts are discussed further, including fraud warning signs. Although detecting fraud is challenging, auditors' awareness of common fraud indicators and detection techniques heightens the likelihood of uncovering misstatements due to fraud.
- Inventory often represents the largest account on a company's balance sheet, presenting a challenge for auditors to confirm its existence and valuation. Inventory is vulnerable to both misappropriation and manipulation by managers aiming to meet financial goals.

Audit Risk

- Fraudulent reporting involving accounts payable is common, albeit less frequent than inventory or accounts receivable fraud. Deliberate understatement of accounts payable typically leads to understated purchases and cost of goods sold, with inflated net income.
- Prevention requires limiting payments to approved vendors and thorough documentation checks before payments. Another misappropriation involves stealing legitimate vendor checks and resubmitting documentation for additional payments, which can be prevented by canceling supporting documents after payment.

Conclusion & Closing

Lecture 11: Auditor's Response to Assessed Risk

Lecturer: Dimaz Ramananda

Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014