

SESSION 6

AUDIT RISK AND BUSINESS RISK

ISA 400 ACCOUNTING AND INTERNAL CONTROL SYSTEMS AND AUDIT RISK ASSESSMENT

Learning Objectives:

- ❖ Identify and describe the need to plan and perform audits with an attitude of professional skepticism.
- ❖ Compare and contrast risk based, procedural and other approaches to audit work.
- ❖ discuss the importance of risk analysis
- ❖ describe the use of information technology in risk analysis
- ❖ identify and describe engagement risks affecting the audit of an entity
- ❖ Explain the components of audit and business risk.

What is audit risk?

Basically, audit risk is the risk arising from carrying out audit work. It is the risk of the auditor 'suffering loss' as a result of giving an inappropriate audit opinion. It is related to materiality, as it is the risk that the auditor come to an invalid conclusion in audit report, namely that either:

- ❖ *The audit report is unqualified but subsequently material error is found in the financial statement.*
- ❖ *The audit report is qualified but subsequently no material error is found in the financial statement.*

The greater audit risk in (1) as it occurs more frequently and there is greater risk of the auditor being sued for negligence than in (2).

This may arise from:

- ❖ Not gathering appropriate audit evidence
- ❖ Being deliberately misled by those providing the evidence who conceal evidence that would have led to a different opinion, or who falsify evidence
- ❖ Misinterpreting (drawing inappropriate conclusions from) the evidence gathered.

Audit risk Model:

$AR = IR \times CR \times DR$

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

Inherent risk

- ❖ That misstatement will occur due to environmental influence and the nature or type of company (i.e. at the entity level) and the nature of individual transaction or balance. Inherent risk depends on the type of business. The following have a high inherent risk:
 1. Integrity of directors and management: Auditors need to be sensitive to the integrity of management and the possibility they may see to manipulate the accounting records and financial statements.
 2. Companies with a dominant chief executive: These can include a need to produced financial statement in a shorter time period than normal or pressure to show improved results such as in anticipation of public listing.
 3. Small and new companies: inexperience management may results in accounting errors such as failure to make necessary adjustments and accounting estimates.
 4. Nature of business: from experience auditors are aware that certain type of business are prone to higher incidence of financial reporting irregularities.

Inherent risk at the account balance and transaction class level:

- ❖ Susceptibility to misstatement
- ❖ Degree of judgement involved
- ❖ Susceptibility of assets to loss or misappropriation
- ❖ Quality of specific accounting systems
- ❖ Unusual or complex transactions at or near the year end
- ❖ Transaction not subjected to ordinary processing

Control risk

- ❖ Is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material either individually or when aggregated with misstatement in other balance or class, would not be prevented or detected and corrected on timely basis, by the accounting and internal control systems

Detection risk

- ❖ Is the risk that auditor's substantive procedures do not detect a misstatement that exist in an account balance or class of transactions that could be material either individually or when aggregated with misstatements in other balance.

Advantages of the audit risk approach:

- ❖ The auditors able to provide justification for the work carried in case the lawsuit against the auditor for negligence.
- ❖ This approach helps the auditors to identify high-risk areas where more work should be performed and low risk areas, where little or no audit work will be carried out.
- ❖ More efficiency way of conducts an audit. It helps to eliminate under or over auditing.

Disadvantages of the audit risk approach:

- ❖ It is very difficult to put a quantitative value on inherent risk. Hence the model may give an impression of accuracy which is unrealistic.
- ❖ For the model to be useful the population involved need to be sufficiently large to allow for valid statistical conclusion to be drawn. This rules out use of the model in many smaller audits
- ❖ Allocating the risk between accounting systems
- ❖ Control risk may not include all factors, which determine the figure in the financial statements.
- ❖ A system using standard deviation of error would be closer to reality.

Business Risks:

What is business risk?

A material error occurring in financial statement is also affected by the nature of audit client business, changes in state regulation, increase competition in market and changes in economy condition of the state. Business risk is the risk that the business will fail to meet its objective.

The main components of business risk:

- ❖ Financial risk
- ❖ Operational risk
- ❖ Compliance risk

Financial risk: where a risk arising from the company activities:

- ❖ Going concern problems
- ❖ Overtrading
- ❖ Credit risk
- ❖ Interest risk
- ❖ Currency risk
- ❖ Breakdown of accounting systems.

Operational risk is those arising from the operation of the business:

- ❖ Missed business opportunities
- ❖ Loss of physical assets
- ❖ Lack of business orders

Compliance risk is those arising from non-compliances with laws and regulations:

- ❖ Breach of Companies Acts
- ❖ VAT problems
- ❖ Health and safety
- ❖ Environmental issues

The followings techniques a used to identify the business risks:

- ❖ Pest analysis
- ❖ Swot analysis

Audit risk is the risk of forming an incorrect opinion on the financial statements and business risk is the risk arises throughout the whole of the operation of business