WEEK 3: AUDIT RISK, INTERNAL CONTROLS AND KEY ASSERTIONS
Audit Risk

Audit Risk

Audit risk (AR) is a function of:

The risk of material misstatement of the financial report

Must be assessed at two levels

Overall level
(i.e. the risks that affect the financial report as a whole)

Assertion level
for classes of transactions, account balances and disclosures

The risk that the auditor will not detect the material misstatement (Detection Risk (DR))

Reduced by proper planning, assignment of staff, professional scepticism and supervision and review

Risk at the assertion level has two components

Inherent Risk (IR)
The susceptibility of an assertion to material misstatement, assuming there are no related controls. IR factors are generally **business risks** (BR) **affecting a specific account assertion.**

Control Risk (CR)
The risk of an assertion being materially misstated because **controls will not prevent, or detect and correct, errors** on a timely basis. CR is the impact of the presence or absence of effective **internal control** designed to **mitigate** entity's **business risks**

Audit Risk
What is the possibility that the auditor may not have uncovered a material misstatement in the financial statements, and thus has *issued an incorrect audit opinion*.

- **"risk that auditor gives an inappropriate audit opinion when the financial statements are materially misstated"**

This could have occurred if the auditor misjudges or fails to understand the existence of the following risk elements:
- **Inherent Risk**
- **Control Risk**
- **Detection risk**

- If you don't do a good job – incorrect audit opinion (insufficient evidence, incorrect assertions etc)
- Misleading audit report
- You didn't look hard enough – is there a risk that you didn't recognise?
- You got your audit opinion wrong (wrong evidence, didn't understand the evidence or misjudged a risk)

Inherent Risk

Inherent risk (ASA 200)
› **Is the possibility that a material misstatement could occur in an assertion, either individually or when aggregated with other misstatements, assuming there are no related controls**

› **Inherent risk exists independently of the audit of financial statements and thus auditors cannot change the actual level of inherent risk**
› **Consider the 3 classes of business risks discussed last week**
  › **Operational**
  › **Financial**
  › **Compliance**

› Externally generated risk
› Very much – business risk related – something outside the organisation's control (govt, market etc)
› Auditor has no control over the external environment – can only judge the level of risk and design audit procedures in light of that assessment
› Risk of misstatement
› Inherent risk is higher for some accounts than others e.g. cash vs plant assets vs finance lease valuations
› Inherent risk is also different from industry to industry – different levels of uncertainty

Inherent Risk
Auditor determines how identified business risks are relevant to the audit client's financial reporting....
Key factors may include:
- **Changes in the operating environment (your market)**
- **New key personnel**
- **New or revamped information systems**
- **Rapid growth (uncontrolled)**
- **Corporate restructuring (target of a takeover)**
- **Pressure to meet investor returns**
- **Pressure to meet loan conditions**
- **Pressure to achieve employee bonuses**
- **Expanding foreign operations**

All of the key factors have inherent risks with potential adverse financial consequences

Control Risk

Control risk (ASA 200)

- › **Is the risk that a material misstatement could occur in an assertion, either individually or when aggregated with other misstatements, and not be prevented, detected, or corrected on a timely basis by the entity's internal control structure?**
- › **Control risk is a function of the effectiveness of the internal control structure as effective internal controls reduce risk**

- › Auditor needs to ensure that the database is of quality
- › Auditor never checks 100% of everything
- › You only check a small % of all the items
- › Auditor relies on the internal controls of the company to be strong (review last week's lecture)
- › Incomplete or erroneous transactions are risks if internal controls are dodgy
- › Mathematically, you are allowed to reduce the population you examine if you believe that the internal controls are strong e.g. you assume that they have properly documented and dealt with their accounts receivables – if the database is quality controlled and you've testing the controls – then you can look at a smaller sample – mathematically still able to come to a valid conclusion
- › Inoperative, overridden or corruption of the rules/internal controls – then the auditor statistically must check more
- › Auditor cannot force mgmt to change or fix internal controls
- › Need pure and quality information – to make informed decisions (from the mgmt's the position) and it is also in the best interests of the auditor as well
- › Auditor cannot actually do anything about it – mgmt's responsibility

Control Risk

1. **Each company will have these rules**
   a) **Some rules will be common across companies and some will be linked to specialised activities**
2. **The rules need to change (updated or amended) as the company activities change.**
   a) **Important if a new business division is started or acquired**
   b) **IT systems change**
   c) **If there are restructuring issues (staff sacked impacts segregation of duties)**
3. **A key rule *"segregation of duties"* costs money (more staff). So even if the rule would protect assets or information, Management may decide not to implement the rule based on a cost benefit analysis.**
4. **Both management and the external auditor need to know if a rule is working*.***

==*Having a rule but it not operating means the rule does not exist.*==

- • Testing of controls is important thing to do and consider
- • "materially accurate"
- • How do you know it was accurate and got to the right account? It all falls back on internal controls

Detection Risk

Detection Risk (ASA 200)

- › **Is the risk that an auditor's substantive procedures will not detect any material misstatements that exist in an assertion, either individually or when aggregated with other misstatements**
- › **Is a function of the effectiveness of substantive procedures and their application by an auditor and thus is fundamental to the amount of audit work undertaken**
- › **actual level of detection risk is controllable by the auditor through:**
   - - **appropriate planning, direction, supervision and review**
   - - **variation in the nature, timing and extent of audit procedures**
   - - **effective performance of the audit procedures and evaluation of their results**

Has the auditor completed sufficient quality audit work?

A key Account –What is it?

- › **A key account is a general ledger account that will be reported in the financial statements.**
- › **A key account needs to be a material general ledger account that if misstated would lead to a *material misstatement* in the financial statements.**
- › **The key account has to be linked to the business risk identified.**
- › **Note more than one key account can require investigation by the auditor on the basis of an identified business risk.**

The **RISK for the AUDITOR** (audit risk) is whether the identified key account's "$" value may be materially ***over or understated***.

Assertions about classes of transactions and events:

The Assertions 2016 Year Forward (ASA 315- Appendix A127 and 128)

› The assertion labels tend to link to <mark>income statement accounts</mark>
- A sale **occurred**
- A sale was **accurate**
- Correct sale **cut-off** (accounting period, the date)

Assertions about **classes of transactions and events**:
- **Occurrence**—transactions and events that have been recorded or disclosed, have occurred and such transactions and events pertain to the entity.

› **Completeness**—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial report have been included.

› **Accuracy**—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

› **Cut-off**—transactions and events have been recorded in the correct accounting period.

› **Classification**—transactions and events have been recorded in the proper accounts.

› **Presentation**—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
- Presentation and disclosure
  - The ledger account appears in the correct location, and the notes to the accounts convey reliable and understandable information to users

- **Know the titles – you what they mean and use them**
- **Determine whether you are looking at a single key account (i.e. transaction)or if you're looking at balances of accounts on financial statements at balance date**

Assertions about classes of transactions and events e.g. SALES

- DIRECTION OF WHERE YOU START IS KEY

- Occurrence – it is real sale (select random transactions – if its real – what would have happened in operating cycle? What documentation? What actioned? Who? How?)
  o Starting point was from the database and traced it back through documentation
  o Starting point = client's records
  o Customer, what was sold? Price? Discounts? Payment terms? (sales invoice)
  o Check an order that was provided by the customer (email, telephone, file note)
  o Sale real and customer real
  o Then the stock be packed and then shipped (internal doc between the two)
  o Courier doc – that the stock was shipped to client on that day
  o Accounts receivable journal entries made
  o Customer – has the account been settled by cash?
  o If the (X) start to be getting large – internal controls may not be working then

- Completeness
  o Make sure the company hasn't failed to correctly record a sale that has occurred
  o Is anything missing?
  o Going from external aspect to the database e.g. deliver stock → is there a sale?
  o You're only worried about if the stock was delivered? – starting point is the courier docket – identify the customer, package details, what was packed, order or invoice ref, check invoice was posted
  o Sales transaction that was valid was not missed

- Accuracy
  o Check mathematics of transaction (quantity x price, subtotals, value of GST, final value on invoice and transferred correctly)

- Cut-off
  o Sales are currently organised into the right accounting period
- Classification
  o E.g. transactions that are separated into different groups
  o It got to the right account
  o Goes to the right sales journal etc
- Presentation
  o Is the sale really a sale?
  o E.g. Desk copy sale (which is written off every month)