## INHERENT RISK & AUDIT RISK MODEL

**Factors affecting inherent risks**

- **Nature of client's business:**
  - value of obsolescent inventory in highly technology industry (computer retailers, electronics manufacturer)
  - music industry (depends on customer references and violate)

- **Result of previous audits:**
  - misstatement found in previous year's audit is more likely to occur again
  - misstatement are systematic in nature
  - organisations are slow in making changes

- **Initial versus repeat engagement:**
  - lack of experience and understanding of clients and its operations
  - risk of not initially identifying problems that existed in the past to considered in design of the audit program
  - Enquiries should be made as to the reasons for the change of auditor
  - Enquiries should be made about the nature of problems evident in the previous year's audit

- **Related parties:**
  - transactions that no occur between independent parties dealing at arm's length are more likely to be misstated
  - parent and subsidiary companies
  - director ands and corporate

- **Non-routine transactions:**
  - might be incorrectly recorded due to lack of recording experience
  - fire losses, major property acquisitions, lease agreement
  - install new computer system: error due to lack of knowledge of new system, error due to lack of skill by employees, fail to implement controls during implementation, misstatements during conversion process

- **Judgment required to correctly record account balances and transactions:**
  - likelihood of misstatement increases when considerable judgment is required
  - doubtful debt, obsolescent inventory, liability for warranty payments, repair vs replacement of assets
  - litigation liability from law sue

- **Makeup of population:**
  - individual items making up total population affects expectation of material misstatement
  - outstanding account receivables for several months
  - cash payment made payable to cash

- **Going concern issue (ASA**
  - Sale of stores to offer short term cash issues,
  - Negotiation with bank to change loan terms, extent repayments

- **Complexity of transactions**
  - Open new brand in overseas: transactions using foreign currency
  - Lease agreement
  - Leave entitlements related to employee issues

- **Factors related to fraudulent financial reporting:**
  - intentional misstatement or omission of amounts or disclosures with intent to deceive users
  - example: capitalised fixed assets that should be expenses, overstate profit by omitting accounts payable and other liabilities
  - ***Earnings management:*** deliberate actions taken by management to meet earnings objectives

- ***Profit smoothing:*** form on earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings. E.g. reduce value of assets at acquisition which results in higher earnings when sold, overstate inventory obsolescent and allowance for doubtful debts in high earnings period
- ATO: issues related to financial reports, potential liability for additional tax/ penalties

- **Factors related to misappropriation of assets:**
  - Theft of an entity's assets → an management concern even if not material

| | Fraudulent financial reporting | Misappropriation of assets |
|---|---|---|
| **Incentives/ pressure** | - Decline in company's prospects<br>- Meet analysts' forecasts or benchmark<br>- Meet debt covenant restrictions<br>- Financial stability or profitability is threatened by economic, industry, entity operating conditions<br>- Management's net worth is materially threatened by company's financial performance<br>- Incentive scheme<br>- Excessive authority given to management | - Employees with excessive financial obligations, drug abuse, gambling problems<br>- Dissatisfied employees caused by:<br>• Known or expected employee redundancies<br>• Promotions, compensation, rewards inconsistent with expectations |
| **Opportunities** | - Industries where significant judgements and estimates are involved<br>- Turnover in accounting personnel<br>- Other weakness in accounting and information processes (i.e. ineffective audit committee and broad of directors' oversight of financial report) | - Companies with accessible cash or other valuable assets<br>- Weak internal controls<br>- Entities where it is difficult to maintain adequate separation of duties |
| **Attitudes/ rationalisation** | - CEO or top management displays significant disregard for financial reporting process (i.e. make overly aggressive or unrealistic forecasts)<br>- Inappropriate/ ineffective communication and support of company's value<br>- Management's character or set of ethical values | - Management's attitude towards control and ethical conduct<br>• Disregard of need to monitor or reduce risk of misappropriating assets<br>• Disregard for internal controls or failing to correct known internal control deficiencies |

**Audit risk model:** formal model reflecting relationships between acceptable audit risk (AAR), inherent risk (IR), control risk (CR), planned detection risk (PDR)
PRD = AAR/(IR x CR)

**Types of risk**

***1. Planned detection risk***
- Risk that audit evidence for a segment will fail to detect misstatements exceeding tolerable misstatement
- Dependent on other risks
- Determines amount of substantive evidence, inversely with size of planned detection
- PDR decreases = more evidence

***2. Inherent risk***
- Measure of auditor's assessment of likelihood of material misstatements before considering effectiveness of internal control
- Inversely related to PDR, directly related to evidence
- Assessment of inherent risk affects amount of evidence, assignment of staff, review of audit documentation
- Factors affecting inherent risk:

### *3. Control risk*

- Measure of auditor's assessment of likelihood that misstatements exceeding tolerable amount in a segment won't be prevented or detected by internal control
- Inversely related to PDR, directly related to evidence
- Auditor must: obtain understanding of internal control, evaluate expected effectiveness based on understanding, test internal control for effectiveness

### *4. Acceptable/ desired audit risk*

- Measure how willing auditor is to accept that financial statements may be materially misstated after audit
- Lower acceptable audit risk = more certain that statements are not materially misstated
- **Audit assurance:** overall assurance, level of assurance, complement of acceptable audit risk

**Types of test:**

- **Test of control:** procedures to obtain understanding of internal control
- **Substantive tests of transactions:** procedures testing for monetary misstatements to determine whether 6 transaction-related audit objectives have been satisfied for each class of transactions
- **Tests of details of balances:** procedures testing for monetary misstatements to determine whether 8 balance-related audit objectives have been satisfied for each significant account balance
- **Analytical procedures**: use of comparisons and relationships to assess whether account balances or other data appear reasonable

**Evidence mix**

| Inherent risk | Control risk | Likelihood of material error | Extent of substantive test | Desired PDR |
|---|---|---|---|---|
| High | High | High | Extensive | Low |
| High | Low | Moderate | Moderate | Moderate |
| Low | High | Moderate | Moderate | Moderate |
| Low | Low | Low | Limited | High |

| Control is effective → low control risk | Control is ineffective → high control risk |
|---|---|
| - Extensive test of control as can rely on control<br>- Extensive test analytical procedures to determine if balances and data appear reasonably<br>- Minimise substantive tests of transactions and balances<br>- High planned detection risk | - Low or no control test as cannot rely on control<br>- Small amount of analytical procedures<br>- Extensive tests of transactions and balances<br>- Low planed detection risk |

- If significant misstatement was found last year, inherent risk is assessed as high in current year, extensive testing of internal control to determine deficiency in control system has been corrected
- If some control and few inherent risks then medium amount of testing for all types, except for analytical procedures where should be done extensively
- More extensive testing required if high inherent risk