

AA

Learning Phase-Audit Risk

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Agenda

- The basic knowledge of the audit risk
- Answer the requirement
- Common problems



LO1: The basic knowledge of the audit risk

The basic knowledge of the audit risk

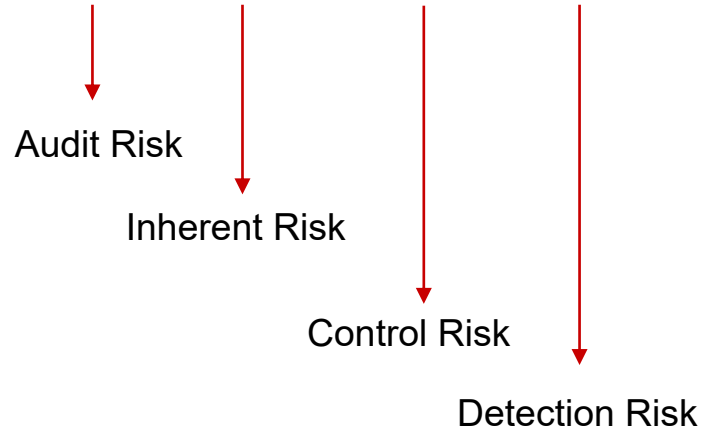
- The IASs require auditors to adopt a risk-based approach to auditing, the auditor needs to consider how and where misstatements are most likely to arise.
- The auditor carries out a risk assessment in order to ensure the areas which are most susceptible to material misstatement are adequately investigated during the audit.
- It is therefore very important that you understand the difference between business risk and audit risk.

The basic knowledge of the audit risk

- **Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
- **Business risk** is the risk inherent to the entity in its operations (at all levels of the business).
- Only the business risk which would influence the financial statements should be considered by the auditors.

The basic knowledge of the audit risk

- The audit risk model



The basic knowledge of the audit risk

- **Inherent risk** is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material either individually or when aggregated with other misstatements, before consideration of any related internal controls.
- Inherent risk is affected by the nature of the entity, for example, the industry it is in; the regulations it falls under; and the nature of the strategies it adopts.

The basic knowledge of the audit risk

- **Control risk** is the risk that a material misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, individually or when aggregated with other misstatements, **will not be prevented or detected and corrected** on timely basis by the entity's **internal control**.

The basic knowledge of the audit risk

- **Detection risk** is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

$$\textit{Detection Risk} = \textit{Sampling Risk} + \textit{Non-sampling Risk}$$

The basic knowledge of the audit risk

- Control risk and inherent risk together make up **the risk of material misstatement**.
- Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- The auditor first **identifies** the risks and then **assesses** their severity.

The basic knowledge of the audit risk

- **Detection risk** is the only component of audit risk that the auditors have control over.
- Audit risk must always be set 'to an acceptably low level' – the risk of the auditor giving the wrong opinion should obviously be as low as possible.
- Auditors will assess inherent risk and control risk as high, medium or low.
- Detection risk is the balancing figure in the audit risk equation. So if inherent risk and control risk are assessed as high, detection risk must be as low as possible for audit risk to remain low.

The basic knowledge of the audit risk

- ISA 330: The auditor's responses to assessed risks
- **Overall responses** include emphasizing to the audit team the importance of professional skepticism, allocating more staff, using experts or providing more supervision.
- Responses to the risks of material misstatement at the **assertion level** include **tests of controls** and **substantive procedures**.



LO2: Answer the requirement

Answer the requirement

(c) From a review of the background and planning meeting notes, and the ratios calculated, describe **SEVEN** audit risks and explain the auditor's response to each risk in planning the audit of Centipede Co. (14 marks)

Answer the requirement

The 14 marks reflects the fact that each risk/response is worth 2 marks which will be awarded as follows:

- For identification of each audit risk – $\frac{1}{2}$ mark each
- For explanation of each risk – $\frac{1}{2}$ mark
- For an appropriate auditor's response to each risk – 1 mark

Answer the requirement -Identify

- This information can be found in the scenario. All of the information in the scenario should be read carefully.
- The scenario will typically contain more than the number of risks required, so it is important that candidates plan their time carefully and only attempt to list the required number of points.
- Financial accounting knowledge is also important as audit risks will often focus on the accounting treatment used in the financial statements.

Answer the requirement -Identify

- It is important candidates use the specific information in the scenario rather than making general statements.

return period. The company also provides a six-month warranty on its products which requires Corley Appliances Co to repair any defects, at its own cost, which arise within the warranty period. It is anticipated that the warranty provision in the draft financial statements will be lower than the prior year as the directors are confident the products sold by the company are built to a very high standard.

- Audit risk is not business risk.

Peach Co has inventories of high-sugar drinks costing \$227,000 which it can no longer sell in its home market due to a lack of demand. The directors believe Peach Co can sell the remaining inventories to an international customer at a price that marginally exceeds cost but Peach Co will be responsible for all costs relating to the delivery and shipping of the drinks.

Answer the requirement -Identify

Key words	Audit risk
New system/customer/business/employee	Unfamiliar
The change of accounting policy and estimates	Irrational
Outsourcing	Hard to obtain the evidence
The inventory with lots of warehouse	Impossible to attend all of the count
Inventory	Impairment (NRV)
The initial measurement of asset(training fee/servicing and maintenance costs)	The calculation of the carrying amount
Return policy/Deposit received	The recognition of sales

Answer the requirement -Identify

Key words	Audit risk
R&D	The capitalization and expense
Contingent event (warranty/sue/dismissal)	Classification and calculation
The breach of the bank terms/ the legislation	Going concern/
New loan	Classification of current & non-current loan
The bonus of the manager related to the profit	Profit manipulation
The financial ratio	The deterioration of the financial ratio

Answer the requirement-Explain

- The explanation of the risk must also clearly state the specific area of the financial statements impacted.
- To explain an audit risk it is necessary to state the relevant financial statement assertion that is affected (e.g. completeness/cut-off/valuation, etc) or whether amounts could be over/under/misstated or the effect on inherent/control/detection risk.

Answer the requirement-Response

- An auditor's response is an approach the audit team will take to address the identified risk; it does not have to be a detailed audit procedure.
- Auditor's response is not management's response

Response to the risk of the fraud committed by the payables ledger supervisor

- ✓ how the company could avoid future frauds
- ✓ there may be other undetected frauds resulting in overstated profit

- Auditor's response is the approach to address the identified risk

- ✓ "Discuss with management" is insufficient
- ✓ Acceptable accounting treatment is not an auditor's response
- ✓ The response should be practical within the context of the scenario



LO3: Common problems

Common problems

New client, lack of knowledge of the business. More likely to miss issues. Also, lack of evidence over the opening balances↵	Use a more experienced audit team↵ Contact the previous auditors and get access to their working papers. Agree opening balances to their file↵
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An little more needed here. With audit responses, say **WHAT** you are suggesting and **WHY**. Here, the more experienced team are more likely to pick up errors, using their knowledge from other clients.

Common problems

Legal action is outstanding / not yet decided. Having a provision or a contingent liability depends on how likely it is that the case is lost, making this a subjective area. ↵	Discuss with legal counsel and get their opinion on how likely it is that the case will be lost. ↵ ↵
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TO make this even better – obtain documentary evidence.

Common problems

There is a difference in the local and international rules on disclosing directors remuneration. There is more scope for the declaration to be incorrect – management may do it wrong, or the auditors might miss the error ↵

Read up on the rules. Consult an internal expert at the firm. Make sure there is an independent review of the audit file before signing the opinion. ↵

Use a disclose checklist to make sure the disclosures has been done right,↵

You scored a decent mark here – but could've done even better by using the numbers / ratios.

The question asked you to do this specifically, so you missed out on easy marks by not using them.

Common problems

No <u>year end</u> inventory count plus there were lots of exceptions in the perpetual inventory count. ⁴	Obtain alternative evidence to support <u>year end</u> inventory. ³
Lack of evidence to support the <u>year end</u> inventory balance, it could be mis-stated. ³	

Too vague to score credit. Say which tests you would perform to obtain evidence.

Common problems

Closure of a site in 2005 might mean that the business is struggling, there could be going concern issues↵	Obtain managements budgets / cashflow forecasts for the future and ensure that the business will continue to be able to trade↵
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- This is a good point – going concern is an issue here.
- Better evidence for this would've been – deteriorating margins / liquidity ratios. Quoting these would've earned you a full mark, rather than just a half.
- A bit vague. Better to say exactly what you would do e.g. ensure that all debt covenants continue to be met, or that the business doesn't run out of cash.



Think Ahead

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