# AUDIT RISK

RELEVANT TO ACCA QUALIFICATION PAPERS F8 AND P7 AND

THIS ARTICLE OUTLINES AND EXPLAINS THE CONCEPT OF AUDIT RISK, MAKING REFERENCE TO THE KEY AUDITING STANDARDS WHICH GIVE GUIDANCE TO AUDITORS ABOUT RISK ASSESSMENT.

**This article outlines and explains the concept of audit risk, making reference to the key auditing standards which give guidance to auditors about risk assessment.**

Identifying and assessing audit risk is a key part of the audit process, and ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, gives extensive guidance to auditors about audit risk assessment. The purpose of this article is to give summary guidance to CAT Paper 8, Paper F8 and P7 students about the concept of audit risk. All subsequent references in this article to the standard will be stated simply as ISA 315, although ISA 315 is a 'redrafted' standard, in accordance with the International Auditing and Assurance Standards Board (IAASB) Clarity Project. For further details on the IAASB Clarity Project, read the article by Lisa Weaver, examiner for Paper P7, in the August 2009 issue of *Student Accountant.*

## WHAT IS AUDIT RISK?

According to the IAASB Glossary of Terms[1], audit risk is defined as follows:

*'The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk.'*

## WHY IS AUDIT RISK SO IMPORTANT TO AUDITORS?

Audit risk is fundamental to the audit process because auditors cannot and do not attempt to check all transactions. Students should refer to any published accounts of large companies and think about the vast number of transactions in a statement of comprehensive income and a statement of financial position. It would be impossible to check all of these transactions, and no one would be prepared to pay for the auditors to do so, hence the importance of the risk-based approach toward auditing. Traditionally, auditors have used a risk-based approach in order to minimise the chance of giving an inappropriate audit opinion, and audits conducted in accordance with ISAs **must** follow the risk-based approach, which should also help to ensure that audit work is carried out efficiently, using the most effective tests based on the audit risk assessment. Auditors should direct audit work to the key risks (sometimes also described as significant risks), where it is more likely that errors in transactions and balances will lead to a material misstatement in the financial statements. It would be inefficient to address insignificant risks in a high level of detail, and whether a risk is classified as a key risk or not is a matter of judgment for the auditor.

## RELEVANT ISAs

There are many references throughout the ISAs to audit risk, but perhaps the two most important audit risk-related ISAs are as follows:

### ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*

ISA 200 sets out the overall objectives of the auditor, and the standard explains the nature and scope of an audit designed to enable an auditor to meet those objectives. References to audit risk are frequently made by ISA 200, and the standard also requires that the auditor shall plan and perform an audit with professional scepticism, recognising that circumstances might exist that may cause the financial statements to be materially misstated. Professional scepticism is defined as an attitude that includes a questioning mind and a critical assessment of evidence.

# CAT PAPER 8

**ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment***

ISA 315 deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through an understanding of the entity and its environment, including the entity's internal controls and risk assessment process. The first version of ISA 315 was originally published in 2003 after a joint audit risk project had been carried out between the IAASB, and the United States Auditing Standards Board. Changes in the audit risk standards have arguably been the single biggest change in auditing standards in recent years, so the significance of ISA 315, and the topic of audit risk, should not be underestimated by auditing students.

The requirements of ISA 315 are summarised in **Table 1** on **page 4**. Let us consider each of these four stages in more detail.

IDENTIFYING AND ASSESSING AUDIT RISK IS A KEY PART OF THE AUDIT PROCESS, AND ISA 315, *IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT*, GIVES EXTENSIVE GUIDANCE TO AUDITORS ABOUT AUDIT RISK ASSESSMENT.

## 1 Risk assessment procedures

ISA 315 gives an overview of the procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered when designing the audit plan. ISA 315 goes on to require that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. ISA 315 goes on to identify the following three risk assessment procedures:

### *Making inquiries of management and others within the entity*

Auditors must have discussions with the client's management about its objectives and expectations, and its plans for achieving those goals.

### *Analytical procedures*

Analytical procedures performed as risk assessment procedures should help the auditor in identifying unusual transactions or positions. They may identify aspects of the entity of which the auditor was unaware, and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

### *Observation and inspection*

Observation and inspection may also provide information about the entity and its environment. Examples of such audit procedures can potentially cover a very broad area, including observation or inspection of the entity's operations, documents, and reports prepared by management, and also of the entity's premises and plant facilities.

ISA 315 requires that risk assessment procedures should, at a minimum, comprise a combination of the above three procedures, and the standard also requires that the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement. Key risks can be identified at any stage of the audit process, and ISA 315 requires that the engagement partner should also determine which matters are to be communicated to those engagement team members not involved in the discussion.

2 Understanding an entity

ISA 315 gives detailed guidance about the understanding required of the entity and its environment by auditors, including the entity's internal control systems. Understanding of the entity and its environment is important for the auditor in order to help identify the risks of material misstatement, to provide a basis for designing and implementing responses to assessed risk (see reference below to ISA 330, *The Auditor's Responses to Assessed Risks*), and to ensure that sufficient appropriate audit evidence is collected. Given that the focus of this article is audit risk, however, students should ensure that they also make themselves familiar with the concept of internal control, and the components of internal control systems.

3 Identification and assessment of significant risks and the risks of material misstatement

In exercising judgement as to which risks are significant risks, the auditor is required to consider the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

4 ISA 330 and responses to assessed risks

The requirements of ISA 330, *The Auditor's Responses to Assessed Risks*, will be covered in a future article, but essentially ISA 330 gives guidance about the nature and extent of the testing required, based on the risk assessment findings.

AUDIT RISK AND BUSINESS RISK

For the purposes of the Paper F8 exam, it is important to make a distinction between audit risk and business risk (which is not examinable in Paper F8), even though ISA 315 itself does not make such a distinction clear. ISA 315[2] defines business risk as follows:

FOR THE PURPOSES OF THE PAPER F8 EXAM, IT IS IMPORTANT TO MAKE A DISTINCTION BETWEEN AUDIT RISK AND BUSINESS RISK (WHICH IS NOT EXAMINABLE IN PAPER F8), EVEN THOUGH ISA 315 ITSELF DOES NOT MAKE SUCH A DISTINCTION CLEAR.

*'A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.'*

Hence business risk is a much broader concept than audit risk. Students are reminded that business risk is excluded from the CAT Paper 8 and Paper F8 syllabus, although it is examinable in Paper P7.

THE AUDIT RISK MODEL

Finally, it is important to make reference to the so called traditional audit risk model, which pre-dates ISA 315, but continues to remain important to the audit process. The audit risk model breaks audit risk down into the following three components:

*Inherent risk*

This 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 controls.

*Control risk*

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

*Detection risk*

This 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.

The interrelationship of the three components of audit risk is outside the scope of this current article. Paper F8 students, however, will typically be expected to have a good understanding of the concept of audit risk, and to be able to apply this understanding to questions in order to identify and describe appropriate risk assessment procedures.

## THE UK AND IRELAND PERSPECTIVE

The UK Auditing Practices Board announced in March 2009 that it would update its auditing standards according to the clarified ISAs, and that these standards would apply for audits of accounting periods ending on or after 15 December 2010.

UK and Irish students should note that there are no significant differences on audit risk between ISA 315 and the UK and Ireland version of the standard.

## CONCLUSIONS

The concept of audit risk is of key importance to the audit process and Paper F8 students are required to have a good understanding of what audit risk is, and why it is so important. For the purposes of the Paper F8 exam, it is important to understand that audit risk is a very practical topic and is therefore examined in a very practical context. Any definition or explanation of the audit risk model itself will usually only be allocated a small number of marks, but many students still include such definitions in answers to case study and scenario questions which require a practical application of audit risk assessment procedures. Students must also be prepared to apply their understanding of audit risk to questions and come up with appropriate risk assessment procedures.

## REFERENCES

1 IAASB Handbook 2009, Glossary of Terms.
2 ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, paragraph 4 (b).

**Martyn Jones is assessor for Paper F8**

THE CONCEPT OF AUDIT RISK IS OF KEY IMPORTANCE TO THE AUDIT PROCESS AND PAPER F8 STUDENTS ARE REQUIRED TO HAVE A GOOD UNDERSTANDING OF WHAT AUDIT RISK IS, AND WHY IT IS SO IMPORTANT. FOR THE PAPER F8 EXAM, IT IS IMPORTANT TO UNDERSTAND THAT AUDIT RISK IS A PRACTICAL TOPIC EXAMINED IN A PRACTICAL CONTEXT.

### TABLE 1: ISA 315 – SUMMARY OF REQUIREMENTS

1 The auditor shall perform risk assessment procedures in order to provide a basis for the identification and assessment of the risks of material misstatement.
2 The auditor is required to obtain an understanding of the entity and its environment, including the entity's internal control systems.
3 The auditor shall identify and assess the risks of material misstatement, and determine whether any of the risks identified are, in the auditor's judgement, significant risks. This is in order to provide a basis for designing and performing further audit procedures.
4 ISA 330 then deals with the required responses to assessed risks.