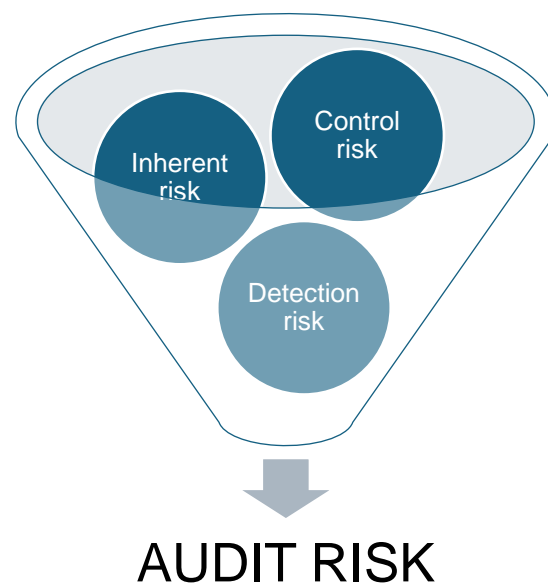


Audit risk and response (Lecture A855 – 21.29 minutes)

Risk assessment is a critical aspect of planning. Understanding how business risk and financial statement risk may impact the audit client is crucial because this can highlight areas where the financial statements contain material misstatement. If planning and/or risk assessment has not been carried out properly, audit risk is increased considerably.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements contain a material misstatement. Audit risk is a function of the risks of material misstatement and detection risk (see below).

There are three components of audit risk:



Inherent risk

This is the susceptibility of an assertion about a class of transaction, account balance or disclosure to material misstatement **BEFORE** the auditor considers any related controls. This risk is beyond the control of the auditor and arises for various reasons include the nature of the industry in which the client operates, the nature of the entity itself or the nature of the item. Inherent risk is a broad concept and can result in material misstatement at the assertion level. For example, where an audit client has a portfolio of derivative financial instruments, material misstatement could arise because such financial instruments are inherently complex to account for.

Notwithstanding the fact that there is guidance in the form of accounting standards for complex financial instruments and disclosure issues, the client could misinterpret, or fail to understand, the requirements which is likely to result in a material misstatement arising in the financial statements.

Control risk

This is the risk that a misstatement that could occur and that could be material, either individually or in aggregate, will not be prevented, or detected and corrected on a timely basis by the entity's system of internal control. Control risk primarily arises in two instances: either controls in place are inadequate or non-existent; or they have not been applied effectively during the reporting period.

Example – Weak bank reconciliation controls

Birchwood Ltd requires bank reconciliations to be carried out every month as part of its month end routine.

In the last four months of the financial year, the bank reconciliation has contained small unreconciled differences. The finance director has informed the audit manager that these will be written off at the year end.

If reconciling items on the bank reconciliation are not investigated and corrected on a timely basis, the cash at bank balance could be misstated in the balance sheet. Unreconciled differences on bank reconciliations may represent a control weakness and even small differences could represent large differences that net off to a small amount.

In combination, inherent risk and control risk make up the risk of material misstatement. This is the risk that the financial statements contain material misstatement prior to the audit fieldwork commencing. Material misstatement could arise due to fraud or error occurring during the year and it is important that the auditor undertakes a thorough programme of planning to identify such risks.

Detection risk

This is the risk that the audit procedures performed by the auditor to reduce audit risk to an acceptable level will not detect a misstatement that exists and which could be material.

Out of the entire audit risk model, detection risk is the only risk that is under the control of the auditor and comprises:

- **Sampling risk** – which is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached had the auditor tested the entire population.
- **Non-sampling risk** – which is the risk that the auditor's conclusion is inappropriate for any other reason such as the application of inappropriate audit procedures, or the failure to recognise a misstatement.

Responses to assessed risks

Once the auditor has identified those risks which may cause material misstatement at the assertion level, they must devise appropriate responses.

Some of the more common risks that are identified in practice, together with their associated responses, are shown in the table below (the table below is not comprehensive and is based on a client preparing financial statements under FRS 102). An auditor's response is not a detailed procedure, the response merely demonstrates the approach the auditor will take in tackling a specific risk. Detailed procedures are developed into an audit plan.

Audit risk

Auditor's response

This is the first year the audit firm has audited this client.

The risk is that the firm has no prior experience of the client and hence detection risk is increased. Opening balances may be misstated as the firm did not carry out the audit last year and the firm is unfamiliar with the accounting systems and policies of the client.

Devote more time to obtain an understanding of the client at the start of the audit to include documenting systems and controls and devising larger sample sizes to reduce detection risk.

Understand the accounting systems and policies and ensure the latter are compliant with FRS 102.

Apply additional procedures over opening balances as required by ISA (UK) 510 *Initial Audit Engagements – Opening Balances* and agree these to the prior year's audit file of the predecessor auditor. Review the previous auditor's responses to the firm to identify any issues which may be relevant to this year's audit.

There is concern that the company may not be a going concern, as there have been significant reductions in sales and little financial headroom.

ISA (UK) 570 *Going Concern* sets out the specific requirements in terms of auditing and reporting on going concern. This will nearly always be a complex area, as it will involve estimates of future performance, the availability of finance or the ability to take mitigating actions (such as selling an asset or part of a business). Where there are indicators of going concern problems, care must be taken to allow sufficient time and expertise to look at the area thoroughly.

During the year an amount of £120,000 was capitalised as development expenditure.

FRS 102, Section 18 *Intangible Assets other than Goodwill* allows capitalisation of development expenditure if it meets the recognition criteria.

If research expenditure has been capitalised, there is a risk that intangible assets and profit are overstated.

Review a schedule of capitalised development expenditure and ascertain the stage of the project to ensure that the costs capitalised are of a development nature and are not research expenditure.

(Note: Intangible assets are a subjective area of the financial statements and hence where there are material amounts of intangible assets that have been capitalised during the year, appropriate responses by the auditor must be developed).

The company acquired a complex piece of machinery during the year and staff were required to be trained in its use. The cost of the training was £16,000.

Review the costs capitalised in respect of the new machine and ensure the costs of training have been written off to profit or loss as required by FRS 102, para 17.11(c).

Training costs are specifically excluded from the cost of an item of property, plant and equipment. If the training costs have been capitalised, fixed assets and profit are overstated.

During the inventory count, a batch of damaged inventory was identified whose estimated selling price less costs to complete and sell was less than cost.

If a write-down to estimated selling price has not been carried out, inventory will be overvalued and cost of sales understated.

The company manufactures complex work in progress (WIP) and the amounts of WIP at the year end are likely to be material.

Determining the quantity and value of WIP may be complex and hence there is a risk of material misstatement in the valuation of WIP.

The company stores inventory at third party bonded warehouses. It is impractical for the audit firm to attend all these warehouses.

There is an increased detection risk over the completeness, existence and valuation of inventory where the auditor does not attend the third-party warehouses.

Trade debtor days in the 90 to 120 days column on the debtors listing have increased from the prior year.

There is a risk that debtors may be overvalued if specific bad debt provisions have not been made against these debtors.

Trace the damaged items to the final inventory valuation and assess whether the items have been written down to estimated selling price. Discuss with management any other items of inventory whose estimated selling price may be lower than cost to assess whether any further write-downs may be necessary.

Review the calculation of WIP and agree the components of the calculation to supporting documentation, such as purchase invoices for materials and payroll records for labour costs. Ascertain the stage of completion of WIP and assess this for reasonableness.

Consider whether the audit firm should use an auditor's expert to carry out the valuation of WIP.

Establish those warehouses which hold material amounts of inventory and attend those. Also attend those warehouses which have had a history of exceptions.

For those warehouses not attended, obtain external confirmation from the warehouse regarding the quantity and condition of the inventory or consider asking another audit firm to attend those which the auditor cannot attend.

Extended post-year-end after date cash testing to establish whether cash has been received from the se debtor after the year.

Note: Obtaining a debtors circularisation letter from these customers would be an irrelevant response in this respect because a debtor's circularisation letter does not confirm the valuation assertion (it only confirms existence).

Discuss with management whether any of the balances in the 90 to 120 days column are irrecoverable and hence whether additional specific bad debt provisions are required.

Note: Under FRS 102, general bad debt provisions (e.g. 5% of total trade debtors) are not allowed. Only specific provisions are allowed.

At the year end, several correcting journals were included in the financial statements to correct errors.

There is a risk that transactions and balances are misstated due to errors.

Review the correcting journals and agree that these are appropriate by reference to corroborating evidence. Also consider the possibility of fraud and whether there is evidence that contradicts any corroborating evidence. Extend cut-off procedures on sales and purchases to ensure transactions are recorded in the correct accounting period.

Discuss with management the reasons for the errors and consider whether the controls over the year-end process require improvement.

Other areas of risk

Other areas the auditor may generally have concerns about at the planning stage, and hence which must be factored into account when carrying out risk assessment procedures including the following (note the list below is not comprehensive):

- Manipulation of the financial statements where there are loan covenants in place in respect of borrowings to maintain those covenants.
- Directors' bonuses which are profit dependent as there is a risk the financial statements may have been manipulated to achieve these bonuses.
- Large profits or losses on disposal of assets recorded in profit or loss as this may indicate that the entity's depreciation policies are inappropriate.
- Complex revenue recognition policies as this could result in revenue being misstated.
- Poor internal controls as this increases the risk of material misstatement.
- Aggressive management styles.
- A desire to achieve a certain level of profit or a desire to reduce profit as much as possible to reduce associated tax liabilities.
- A frequent change of auditor.
- Errors in opening balances that remain uncorrected.
- A tolerance of petty theft (this is a fraud risk factor).
- A failure to address issues raised by the auditor in previous audits (e.g. poor or absent internal controls).
- Inadequate disclosures being made in the financial statements (for example in relation to provisions and contingent liabilities, post-balance sheet events or going concern issues).

- An unwillingness by management to accept any other audit opinion other than an unqualified opinion (this creates an intimidation threat for the auditor).