Chapter 5

The risk-based approach to audit: audit judgement
Learning objectives

• To define audit risk and suggest why risk-based approaches have become more important in recent years.
• To identify the components of audit risk and give practical explanatory examples.
• To identify risk in a number of practical scenarios and show how auditors approach risk.
• To define business risk, show how business risk approaches differ from audit risk approaches and whether relevant to the audit of companies of all sizes.
• To show how enhanced expectations of corporate governance have increased business risk.
• To explain why business risk approaches by auditors may widen the audit expectations gap.
• To explain why judgement is a vital aspect of accounting and auditing.
• To make the distinction between judgement and technical compliance with accounting standards.
• To explain the relationship between audit judgement and audit risk.
• To suggest what it is that enables successful audit judgements to be made.
Why is risk-based approach an aid to auditor?

• Auditor must obtain reasonable assurance financial statements are free from material misstatement – obtaining sufficient appropriate evidence reduces audit risk.
• Auditor is not expected to give absolute assurance.
• Existence of ‘material misstatement’ means that financial statements may not be true and fair.
• Auditors identify and assess risks of material misstatement:
  – at financial statement level – risks pervasive to financial statements as a whole – could affect many assertions
  – at the assertion level – affect individual transactions, balances, disclosures
• Assertions provide audit objectives.
• Auditor addresses both business risk and audit risk.
Why is risk-based approach an aid to auditor?

- **Audit risk** – risk that auditor expresses an inappropriate audit opinion
- **Business risk** – risk that could adversely affect entity’s ability to achieve its objectives – could affect audit risk
- Risk of material misstatement:
  - two entity components: inherent risk and control risk
  - one audit component: effectiveness of an audit procedure – detection risk
- **Inherent risk** – susceptibility of assertion to material misstatement, assuming no related controls
- **Control risk** – risk material misstatement could occur that internal control will not prevent, detect and correct on a timely basis
- **Detection risk** – risk auditor will not detect a material misstatement
Broad approach to minimize audit risk

1. Investigate legitimacy of entity and integrity and competence of management before acceptance of audit assignment, and before subsequent audits.

2. Consider independence of audit firm and staff before acceptance of audit assignment, and before subsequent audits.

3. Understand nature of entity and its environment before commencing detailed audit work.

4. Auditor plans to minimize risk of failing to detect material misstatement at financial statement and assertion levels.

5. Design audit approach on basis of what is known about audit client: set performance materiality; form engagement team with required experience and skills.

6. Perform audit programmes to obtain evidence necessary to form conclusions at assertion level, leading to opinion on truth and fairness of financial statements taken as a whole.
### Broad approach to minimize audit risk

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#### Examples of objectives: Attaining a certain level of profitability; Maximising shareholder wealth; Ensuring efficiency and effectiveness of operations; Meeting a desired market share; Giving customer satisfaction, however that might be measured; Maintaining a desired level of liquidity; Maintaining reputation; Meeting the challenge of changes affecting the entity as they occur; Adherence to accepted principles of corporate governance, including adherence to predetermined measures of environmental protection. |

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| The risk that the competitive tendering process has forced auditors to accept an unreasonably low fee, thus restricting time available to perform an effective audit (audit quality) and/or increasing pressures on independence in fact. A further engagement risk is that auditors may accept clients whose inherent risk at the entity level is unduly high, because, for instance, of management with low integrity. | At the financial statement level | At the assertion level | Factors: 
- Reducing CR
- Inherent limitations: trade-off between cost and benefit; not directed to non-routine transactions; human error; collusion to circumvent controls; overriding internal controls; controls not keeping pace with change (2) Complex computer systems. | Materiality risk and sampling risk |
| Examples of relevant factors: Management integrity; Management experience and competence; Unusual pressures on management; Nature of entity’s business; Nature of industry; Complex computer systems. | | | | Quality control risk |
| The auditor fails to collect sufficient appropriate audit evidence and/or to evaluate it properly. | | | | The risk that, even though the auditors’ procedures have detected misstatements that cause the financial statements NOT to give a true and fair view, the auditor may fail to report the misstatement because of lack of independence in fact. |
| | | | | |
Edencroft Ltd (1) - risk arising from nature of the environment

• Major business risk is volatility of property market, often resulting from changes in interest rates – leading to inherent risk (that properties may be overvalued or going concern status at risk) from the nature of the environment in which the company operates.

• Possible controls to reduce this inherent risk:
  – review of economic indicators by knowledgeable, trustworthy and experienced people to detect whether the economy might be overheating and that interest rates might in consequence rise – allowing timely withdrawal from the more speculative property market.
  – review of borrowing requirements, to keep them to a minimum, and the use of forecasts, including cash forecasts.
Edencroft Ltd (2) - risk arising nature of transactions and balances

• An inherent risk arising from nature of transactions and balances in its lettings activity is that tenants may fail to pay the rent on the due dates or fail to pay at all.

• Possible controls to reduce this inherent risk:
  a) Identified responsible persons to check credentials of potential tenants and for chasing up payment when due.
  b) Vetting before letting to tenants, such as requiring bankers references and character references from reliable individuals.
  c) An accounting system recording amounts due and the issue of timely reminders if tenants fall behind with their rent.
  d) Requiring tenants to pay by bank standing order.
  e) Giving discounts for timely payments.
Estimates in accounting – exercise of judgement

- Likely profitability of long-term construction contracts.
- Reserves in the mineral oil industry.
- Future cash flows where there is some doubt about the going-concern status of the entity.
- Effect of technological change on the value of current inventories or the impairment of non-current assets.
- Amount of significant accrued liabilities such as pension obligations.
- Judgement about fair values.
- Judgement about the outcome of litigation in respect of claims against the entity.
- Estimates of the realizable value of property or equipment held for disposal.
Approach to the components of audit risk

- Audit risk (AR) = Inherent risk (IR) x Control Risk (CR) x Detection Risk (DR)
- See Table 5.1:

<table>
<thead>
<tr>
<th>AR</th>
<th>IR</th>
<th>CR</th>
<th>DR</th>
<th>100% – DR (confidence level)</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>100%</td>
<td>50%</td>
<td>10.0%</td>
<td>90.0%</td>
<td>Low DR and high confidence level because IR is high and CR relatively high. If high confidence (and 90% is high) is required, the auditor would have a level of testing to provide that confidence.</td>
</tr>
<tr>
<td>5%</td>
<td>100%</td>
<td>30%</td>
<td>16.7%</td>
<td>83.3%</td>
<td>IR is again high, but CR is lower (controls are better), so that confidence level need not be so high, resulting in a lower level of testing.</td>
</tr>
<tr>
<td>5%</td>
<td>50%</td>
<td>40%</td>
<td>25%</td>
<td>75.0%</td>
<td>IR is lower, but CR is somewhat higher, possibly because the company considers that tight controls are not necessary. Net effect is that confidence level required is lower than the previous case.</td>
</tr>
</tbody>
</table>
Kemback Ltd(1) – Inherent risks

• Manufacture of clothing for young people – may lack consumer loyalty; may be wide swings of fashion – risk stocks will prove unsaleable

• ‘Trendy’ staff with marketing background may fail to apply company control rules, such as banking takings intact, or committing the company to purchase goods that may prove unsaleable.

• Distance of shops from HO - inherent risk arising from company structure

• Controls include:
  – Market research to identify fashion trends
  – Careful selection of shop staff
  – Training for shop managers to ensure they exercise properly their supervisory role and maintain enthusiasm of staff.
  – Training of staff in accounting/control matters/company policies.
  – System of weekly reporting to HO
Kemback Ltd (2) – particular control
Internal audit work at branches

• Review of weekly returns, including weekly profit and loss statements.
• Seek explanation for trends and to highlight unusual matters, such as poor sales record, turnover of staff and shortfalls in inventories or cash.
• Observe counts of inventories and calculate value. Reconcile to previous counts of inventories carried out by shop personnel.
• Count cash in shop – tills and float. Reconcile till cash to till rolls.
• Check cash is banked intact by reconciling till rolls and bank deposits on a test basis.
• Check receipts of inventories to head office records and test cut-off at time of count of inventories.
Business risk approach to audit

• Possible objectives of entity:
  – Attaining certain level of profitability
  – Maximizing shareholder wealth
  – Ensuring efficiency and effectiveness of operations
  – Meeting desired market share
  – Giving customer satisfaction
  – Maintaining desired level of liquidity
  – Maintaining reputation
  – Meeting challenge of changes affecting the entity
  – Adhering to principles of corporate governance

• Firms using business risk approach look at wider issues than truth and fairness of financial statements.
Activity 5.14 - Kellie case

- Why will increase in market share benefit company?
- Why will increase in market share improve profitability?
- Will company have financial resources to fund growth?
- How will changes in economic climate will affect company?
- Will company have human resources to allow growth?
- Who are major competitors; how will they react to entity’s presence in market and rapid growth?
- What feedback from customers and potential customers?
- Is the company overstretching itself financially?
- Rapid growth – entity may extend credit to individuals and companies new to them.
- Questions for auditor:
  - Is going concern status at risk?
  - Is there a risk of bad debts?
  - Value of work on projects not yet invoiced?

Case suggests auditors can achieve both audit aims and help management to achieve company objectives of only indirect significance to the financial statements.
Earnings management and income smoothing (1)

- Two definitions:
  - Healy and Wahlen (1999): ‘Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.’
  - Walker (2013): Earnings management is ‘the use of managerial discretion over (within GAAP) accounting choices, earnings reporting choices, and real economic decisions to influence how underlying economic events are reflected in one or more measures of earnings.’
Earnings management and income smoothing (2)

• Income smoothing may be defined as measures that serve to reduce fluctuations in the earnings of an entity’. It can range from good business methods through short-term measures that affect earnings, which are not necessarily in the long-term interests of the entity, to fraudulent reporting.

• Example of good business method – bonuses to staff based on profit, resulting in reduction of profit in good years.

• Examples of short-term measures not in long term interests of entity – cutting R&D or cutting maintenance expenditure.

• Examples of fraudulent reporting – understating accounts payable and cost of goods sold in years where earnings are low and omitting assets such as accounts receivable in good years or being overly prudent in some years taking up profit on construction contracts – and vice versa in other years.
Earnings management and income smoothing (3) – reasons why

- Profits have been adversely or favourably affected by conditions unlikely to be repeated.
- Remuneration of key people within the entity often tied to reported earnings. Income smoothing avoids swings in remuneration.
- To influence decisions by external investors and analysts. E.g. it might also be used to influence the entity’s share price.
- ‘Big Bath’ provisions at time of reorganization or management takeover, reversed in later years to make the ‘new company’ look good
- To influence perceptions of financial strength by third parties – present and potential competitors, customers, suppliers, employees, politicians and regulators and providers of finance, where debt covenants are in danger of being infringed.
Business risk and inherent risk approaches: similarities

1. Approaches to business risk and inherent risk both use ‘top-down’ approach initially – entity considered in entirety

   Decide steps necessary to prevent company achieving objectives or – in auditors’ case – perform procedures to ensure financial statements give a true and fair view of results and financial position.

2. Factors that increase inherent risk, such as management inexperience and lack of skills, may make it less likely that business objectives will be obtained.

3. Factors increasing control risk, e.g. poor control environment, may inhibit achieving business objectives.

4. Analysis of business risk and inherent risk helps auditors design work to prove financial statements give a true and fair view. Both kinds of analysis give auditors a better understanding of the entity and its operations.
Business risk and inherent risk approaches: dissimilarities

1. a) Auditors consider inherent risks in relation to impact they may have on financial statements

1. b) Business risk approach considers risks that inhibit the company in achieving its objectives. Many company objectives have little or only an indirect bearing on the financial statements.

2. While factors that fail to reduce impact of inherent risk may also fail to reduce impact of business risk, business and audit objectives are so dissimilar that the factors cannot be regarded as creating a similarity.
Impact that a business risk approach might have on the audit process

1. Improves basic audit of financial statements and makes less likely erroneous conclusions will be reached.
2. Makes audit more efficient and more profitable.
3. Expands potential for giving assurance to management beyond traditional audit and ‘adds value’ to audit from client perspective.
4. Expanded audit has potential to contribute to corporate governance arrangements and disclosures because of broader understanding of business and its risks.
5. Better understanding of client’s business and its risks will reduce audit firm’s own ‘business risk’ – sometimes referred to as ‘engagement risk’.
The business risk approach and smaller clients and smaller audit firms

- Business risk approach needs wide variety of expertise within firm to identify business risks and allow dialogue on equal terms with experts in client company.
- Business risk approach most appropriate in the audit of large multinational companies by the Big 4 audit firms?
- But business risk approach is about attitude of mind on auditor’s part – involving acquiring knowledge about business rationale.
- Small audit client does not usually have wide expertise and smaller audit firms may usefully discuss business risks with management as an aid to them.
- This means that firms other than large firms might be able to use business risk approach.
- Wider approach more expensive, but benefits could exceed costs.
Analytical review as risk analysis tool

• Analytical procedures: ‘evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.’

• Important risk assessment procedures when obtaining an understanding of entity and environment.

• Aid in reducing overall audit risk and in particular reducing detection risk.

• Of particular value in determining whether going-concern problems.

• Used at several points in the audit process.
Judgement in accounting and auditing and its relationship to risk

• Judgement is intangible in its nature.
• The relationship between audit judgement and risk is direct, as it is exercised in the context of risk.
• In forming judgments, auditor makes initial risk assessments and then modifies them on basis of controls in existence and of the validity of figures in the accounting records. Any assessment of risk involves judgement.
• Auditor judgement exercised in context of audit evidence collected and evaluated.
Management of the audit process

• Two basic audit objectives:
  1. To form opinion on financial statements, requiring audit firm to act effectively and to perform professional work of high quality
  2. To make a profit in carrying out professional duties, requiring audit firm to act efficiently as well as effectively.

• Starting point is logical structure within audit firm and allocation of special responsibilities to each person working in it, including:
  – Leadership of the audit firm
  – Ethics partner
  – Engagement quality control reviewer (EQCR)
  – Members of the Engagement Team:
    ▪ The engagement partner
    ▪ Managers
    ▪ Seniors
    ▪ Assistant auditors
    ▪ Support staff including tax and IT experts

• Engagement team supported by Technical Advisory Function.
Notes
1. Leadership of the Audit Firm creates the Firm’s Control Environment.
2. Similarly, the Audited Entity creates the Entity’s Control Environment.
3. The Ethics Partner helps to create and maintain the firm’s Control Environment.
4. An important element of the Entity’s Control Environment comprises the role of Those Charged With Governance.
5. The Technical Advisory function gives advice on audit procedures and reporting to the Engagement team via the Engagement Partner.
6. The Engagement team comprises the Engagement Partner, Manager(s), Other Audit Staff, and Other Professional Staff (e.g., IT, etc.) providing services to the team.
7. The Ethics Partner communicates possible breaches of the firm’s policies and procedures to the Engagement Partner.
8. The Engagement Partner evaluates and reports back to the Ethics Partner and course of action is decided.
9. In the event of disagreement between the Engagement Partner and the Ethics Partner, the matter may be discussed with the Engagement Quality Control Reviewer and resolved.
10. The existence of potential threats to objectivity and independence, and safeguards communicated to Those Charged With Governance at the Audited Entity.
11. The Engagement Partner and the Engagement Quality Control Reviewer discuss significant matters arising from the audit.
12. Those matters also communicated to Those Charged With Governance at the Audited Entity.
13. Any member of the Engagement team are empowered to communicate with the Ethics Partner.
14. The Engagement Partner prepares the draft Audit Report on the basis of conclusions of the Engagement team.
15. The Engagement Quality Control Reviewer reviews individual procedures and conclusions of the Engagement team.
16. The Engagement Quality Control Reviewer reviews the draft Audit Report before it is finalized.

* The asterisk indicates all those persons who are in a position to influence the conduct and outcome of the audit. This includes some or all of the leaders of the audit firm. These are the people known collectively as the ‘audit team’ by the IFAC Code.
The letter of engagement: role and contents

• Letter addressed to person with management authority, including TCWG, containing reference to:
  – Objectives and scope of the audit
  – Responsibilities of the auditor
  – Responsibilities of directors
  – Audit reporting
  – Fees

• Sets scene for relationship between management and auditor – prevents subsequent disagreements.

• Matters that may be emphasized:
  – Duties of management if financial statements on internet
  – Fact that audit report will contain a disclaimer that audit firm only responsible to entity and shareholders as a body and not third parties
  – Auditors’ duties with respect to corporate governance

• If the audit firm is providing non-assurance services, appropriate to prepare separate engagement letter.
Planning the assignment

• County Hotel Limited case designed to help students’ understand planning of assignment. Matters covered are:

Study of the business:
• Typical kinds of hotel and the competition they might expect.
• The major business and inherent risks in the industry and controls introduced.

The internal environment:
• Broad functions in hotels
• Typical sources of income of hotels
• Typical kinds of expenditure in hotels
• Kinds of records hotels keep and evidence available to auditor
• Information management needs to run the hotel profitably and effectively in relation to: accommodation – restaurant – bar – functions – accounting system
• Preparation of audit planning memorandum
• Preparation of time and fee budgets
Figure 5.1 Components of audit and business risk

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<td>Examples of relevant factors: Susceptibility to misstatement or loss; complexity; judgment in determining quality of accounting systems; completion of unusual or complex transactions, particularly at or near year-end; transactions not subjected to ordinary processing</td>
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**The risk that, even though the auditors’ procedures have detected misstatements that cause the financial statements NOT to give a true and fair view, the auditor may fail to report the misstatement because of lack of independence in fact.**
Figure 5.2 Organization Chart of County Hotel

- Managing director: David Jones
  - Restaurant/bars: Edward Whitehill
    - Restaurant manager
      - Restaurant
    - Chief chef
  - Accounting and finance: Carol Henshaw
    - Accounts
    - Cashier
    - Computer department
  - Reception house-keeping: Janet Jones
    - Reception
    - Housekeeping
    - Hotel maintenance
    - Bar manager
    - Cleaners
    - Laundry
    - Maids