

A Practical Approach to Understanding Audit Risk

Alan W. Anderson, CPA

ACCOUNTability  Plus, LLC

Simply, audit risk is the risk the auditor faces in issuing an audit opinion when the audited financial statements contain a material misstatement. The auditor plans and carries out the audit to minimize this risk.

The Audit Standards Board issued Statements on Auditing Standards nos. 104 to 111 in 2006, requiring the auditor to – whether due to errors or fraud – understand and respond to risk of material misstatement. In reaching that understanding, auditors must identify risks to the entity’s business, and the controls in place to mitigate them.

Since these “Risk Assessment Standards” were issued, the audit profession appears to treat audit risk as a new and unique concept. Despite this increased emphasis on audit risk, audit risk is *not* a new concept. Audit risk has been around since the first audit opinion and will continue to be around until the last audit opinion is issued.

AUDIT RISK IS NOT A NEW CONCEPT

The real purpose of issuing these risk assessment standards was to improve the quality and effectiveness of audits by providing more clarity in how the auditor must consider risk when planning and performing an audit. Fundamentally, there is very little in these new standards that was not already required by previously existing audit standards. Unfortunately, these as new concepts have resulted in the standards being over implemented; thus, adding significant time and cost to the audit without adding value to an improvement in the audit quality.

WHY IS AUDIT RISK SO IMPORTANT TO AUDITORS?

Audit risk is a cornerstone to the audit process because auditors cannot and do not attempt to verify 100% of all transactions. Consider a company of any size and think about the sheer number of transactions that occur on a daily basis. Yes, it is possible to verify all of these transactions, but no one is prepared to pay for the auditors to do so. A risk-based approach toward auditing is the only practical solution.

Traditionally, auditors have used a risk-based approach to minimize the chance of issuing an inappropriate audit opinion. All audits are required to follow a risk-based approach to ensure that the audit work is carried out efficiently by applying the most effective audit procedures in the audit areas that carry the greatest risks. Accordingly, it would be inefficient for the auditor to place the same level of testing effort in less risky audit areas. This is all a matter of the professional judgment of the auditor.

TOP DOWN APPROACH TO AUDIT RISK

All too often, audit risk is considered at the individual transaction level without first considering the overall risk at the financial statement level. Starting at the highest level, the auditor should ask: *what accounts or classes of transaction present the greatest potential risk of material misstatement?* Those accounts or classes that present the greatest risk should be the accounts upon which the auditor focuses.

A top down approach is a more direct approach to audit planning and audit testing. The auditor should determine **what could go wrong** in the high risk accounts and design detailed audit procedures that address the risk of material misstatement. The remaining accounts that are not deemed to be of higher risk can be audited using streamlined and/or analytical procedures.

Most standardized audit approaches have detailed steps and procedures for all accounts and classes of transactions. These standardized approaches do not take into consideration the client's high-risk areas or the degree of complexity. These approaches generally include everything because the assumption is that all accounts are high risk. The auditor is expected to use professional judgment to modify the audit procedures based upon the risk of material misstatement assumed in each audit area. If the auditor uses a top down approach, however, there can be quick adjustments for those areas of less risk to the standardized audit programs.

EVALUATING INTERNAL CONTROL RISK

Previous audit standards provided the auditor with the ability to "opt out" of evaluating internal control by classifying internal control risk as high. The auditor generally only needed to know the flow of transactions in order to plan the audit. The risk assessment standards eliminated the ability to opt out and required the auditor to evaluate the design and implementation of internal control to properly identify and assess risk.

Implementing and applying this standard has been difficult for many firms because those firms have primarily always chosen to opt out. These firms didn't have a good understanding of internal controls because they always went with a substantive audit approach.

Using the top down approach discussed above, certain accounts and/or classes of transactions may be eliminated from the internal control risk assessment because the auditor has concluded that certain accounts are not high risk. Evaluating internal control on accounts that are deemed

to be low risk is wasted effort since it has already been determined the accounts do not have any risk of material misstatement.

Determining the scope of internal control test work presents a challenge to many firms. The scope of the work is a function of the audit plan. If the auditor is not intending to rely on internal control to reduce detail testing, then the auditor only needs to determine if the design of internal control surrounding those high-risk audit areas has been implemented. Testing implementation of the design of internal control is typically carried out by performing a “walkthrough” to determine if the key control or controls are in place.

If the auditor is planning to reduce the extent of detailed audit procedures by relying upon the internal controls being in place to prevent or detect a material misstatement, the scope of internal control testing needs to be increased beyond the performance of a walkthrough. The auditor needs to test the operating effectiveness of the internal controls. These compliance tests are typically performed on very large companies or organizations since they are determined to be cost beneficial. Tests of the operating effectiveness of internal controls for smaller companies or organizations are generally not cost beneficial.

DETERMINING NATURE AND EXTENT OF AUDIT TESTS BASED UPON AUDIT RISK

Most auditors were under the impression risk assessment standards required them to perform more audit steps than previously and braced themselves to incur significantly higher costs. This belief became a self-fulfilling prophecy and many firms didn’t truly challenge what they were doing. If the risk assessment standards did, in fact, cause the auditor to perform more audit procedures than in the past, the auditor may not have been performing sufficient audit procedures. This *more work* syndrome, however, appears to be work performed in the less risky areas of the audit that may be unnecessary.

Risk assessment is an important part of planning because it gives the auditor the opportunity to consider what risks may have changed from the previous year. Once determined, the auditor should consider how those changes impact the audit procedures for the current year. Only the auditor can determine the nature and extent of additional procedures.

It is difficult for an auditor to stop performing an audit procedure performed in previous years regardless of the risk associated with the account or class of transactions in the current year. Further, the continuation of the “Same as Last Year” or SALY approach to planning perpetuates the performance of unnecessary audit steps in less risky audit areas.

The top down approach to risk assessment is a way to determine the areas of high risk and those areas of low risk. However, this determination will not reduce the extent of testing by itself. The auditor must challenge what they have done in previous years and make changes in those areas of low risk.

SUMMARY

Most firms use standardized audit risk methodologies and audit packages. These methodologies and related forms are designed to assist the auditor in complying with the requirements of professional standards, but they should not be deemed to be the standards themselves. An auditor can easily comply with the risk assessment standards without completing all of the forms for smaller low-risk audits if they take the time to think about the intent of these standards.

Audit risk is all about targeting the audit approach to those areas with the greatest risk of material misstatement. The top down approach to risk assessment is a way to target audit planning and audit procedures to primarily focus on those areas of the greatest risk. Once these areas are determined, the audit program should be modified to make certain that adequate substantive procedures are being performed in those high risk areas. Conversely, the audit procedures should be reduced in those areas that are deemed to be of low audit risk.