

Risk Based Auditing

Meaning of risk



Risks are the set of circumstances that hinder achievement of objectives. It's an uncertainty of an event occurring that could have an impact on the achievement of objectives.

The three components of risk are:

1. Risk Event (*R*)
2. Probability of Risk Event (*P*)
3. Impact of Risk Event (Risk Event Value) (*I*)

Risk Event is a discrete occurrence that may affect the project for better or for worse. Risks are measured in terms of consequences and likelihood

Mathematically $R = P * I$

Audit Risk and its Types

Audit Risk is the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated. Audit risk is controlled and determined solely by the Auditor.

The risk may be reduced to an acceptable level by designing and performing audit procedures to obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusion on which to base the audit opinion. Audit Risk therefore considers two base risks:

- Financial Statements may be materially misstated prior to the audit (financial statement risk/risk of material misstatement)
- And that auditor may not detect such risks (detection risks)

Financial Statement Risk /Risk of material misstatement

These are the risk that the financial statements are materially misstated prior to audit. The risks of material misstatement may exist at the overall financial statement level and the assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk.

- a) **Inherent risk**—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 control.

Indicative Inherent Risks

- ▶ Doubts about the integrity of management
- ▶ Management inexperience in preparation of the financial statement
- ▶ Accounts, which involve a high degree of estimation

- ▶ Entity lacks sufficient capital to continue operations
- ▶ Potential for technological obsolescence
- ▶ Complex underlying transactions and events
- ▶ Complex capital structure
- ▶ Highly desirable and movable assets (e.g. cash)
- ▶ Unusual/complex transactions at or near the period end
- ▶ Numerous locations and geographical spread
- ▶ Changes in demand
- ▶ Transactions not subject to ordinary processing

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

- ▶ Control Risk is assumed to be high unless
 - internal controls which are likely to prevent / detect / correct material misstatements relevant to the assertions are identified, and
 - test of operating effectiveness (of controls) are planned to be performed to support the assessment
- ▶ Control risks will be assessed as high
 - internal controls are not assessed to be effective or
 - evaluating the operating effectiveness of the controls would not be an efficient audit approach or
 - sufficient audit evidence can purely be achieved from substantive testing

Indicative Control Risk

- ▶ History of errors found by auditor
- ▶ Management attitude/dominance
- ▶ Inexperienced/incompetent staff
- ▶ Lack of segregation of duties
- ▶ Inadequate supervision
- ▶ Size of entity/accounting systems

- ▶ Non Compliance of management policies
- ▶ Weaknesses in safeguard of assets
- ▶ Inability to produce timely financial statements
- ▶ Inaccuracy of financial information
- ▶ Disorderly conduct of businesses

Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements. Inherent Risk is the risk inherent in the nature of the organization, its type of transactions.

Detection Risk

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. Factors to be taken into account for detection risk

- ▶ possible selection of inappropriate audit procedures (AT PLANNING STAGE)
- ▶ misapplication of audit procedures (AT EXECUTION STAGE)
- ▶ misinterpretation of test results (AT REVIEW STAGE)

Methods of Varying Detection Risk

Audit Action	Examples
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Change <u>NATURE</u> of the audit work	<ul style="list-style-type: none"> • Direct confirmation from independent parties rather than relying on documentation within the entity • Physical verification • Use extensive test of details in addition to analytical tests
Change <u>EXTENT</u> of the audit work	<ul style="list-style-type: none"> • Use larger sample size
Change <u>TIMING</u> of the audit work	<ul style="list-style-type: none"> • Perform audit procedures at the period end rather than at interim visit or much later than the end of the reporting period.

Risk Based Auditing (RBA)-Reasons, Values

Risk Based Auditing (RBA) approach is for selecting the audit units under a larger Entity having several down level units/ Sections/Branches.

In case of Independent Entities, This approach may not be applicable, so refer legal provisions and other regulatory requirements before deciding for RBA .RBA Approach can be used for:

- Selecting units to which to audit (Selecting Units), and
- Selecting Transaction within selected audit units (Selecting items for Examinations)

Reasons (Why RBA):

Some of the reasons for selecting RBA over traditional auditing are as per below:

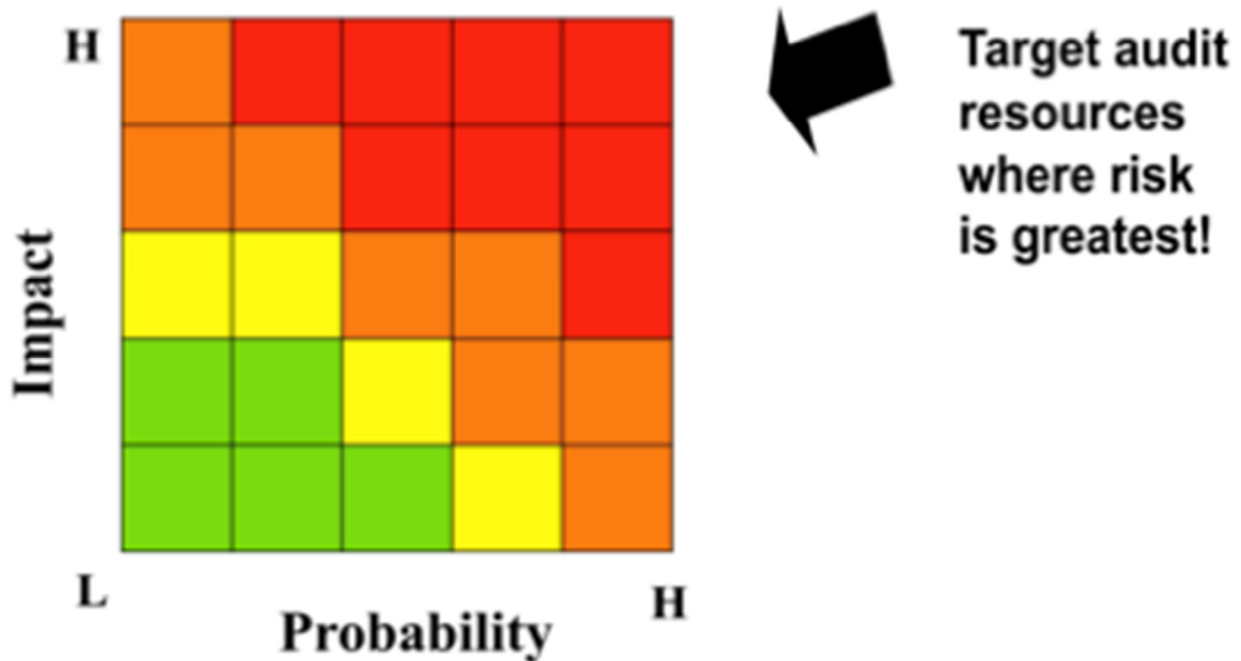
- Limitation of Manpower at Practitioner's firm
- Large and Increasing number of audit units
- Expediency for Audit Report

Values of RBA

- Foster dedicated audit coverage to high risk areas (for minimising audit risk)
- Disciplined approach to evaluating audit universe

- Highlight potential risk otherwise unknown
- Allocate resources where payback is greatest (for quality of audit report)

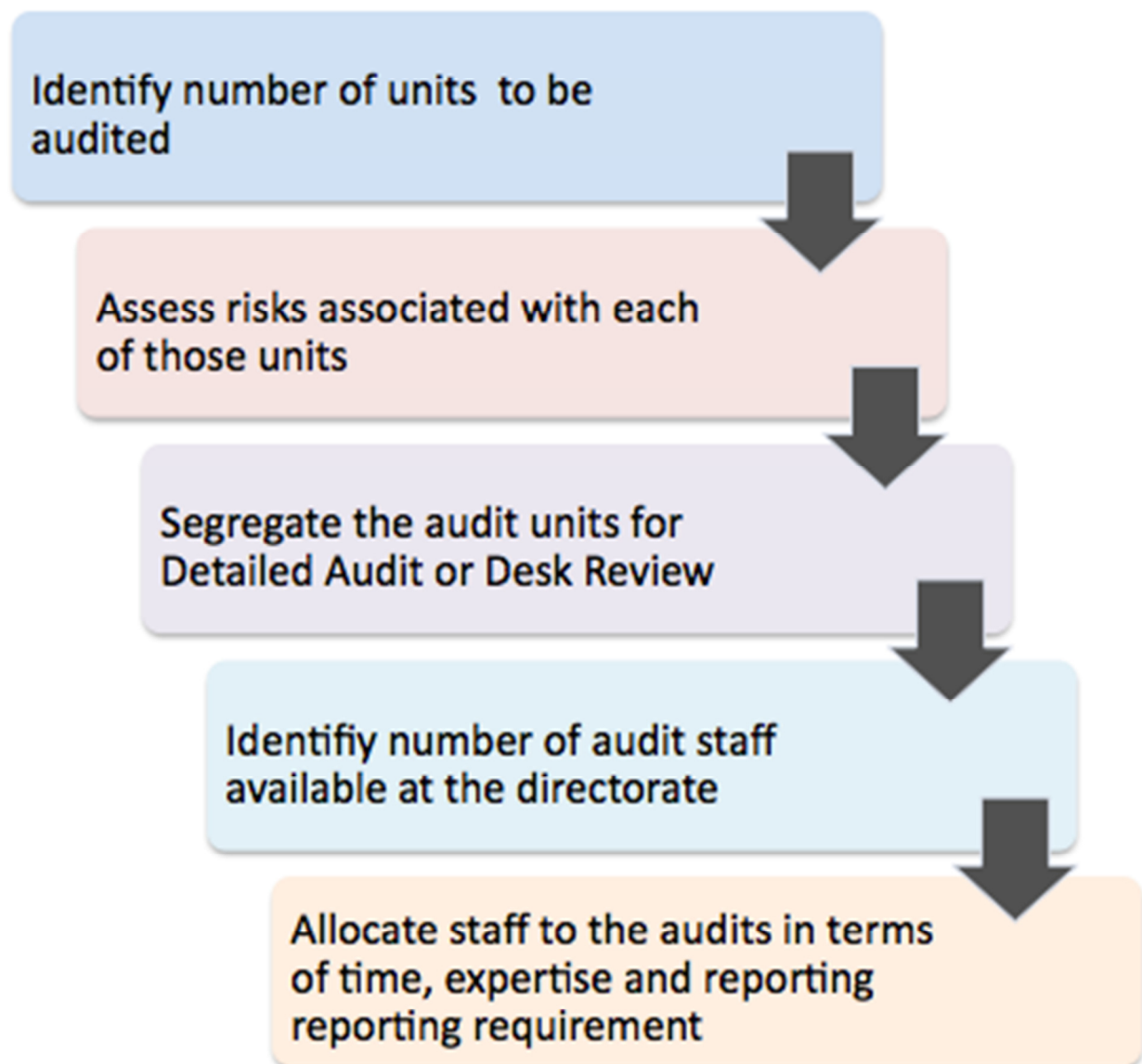
RBA Selection-Justification



Score based selection of audit Units

- Risk Factors (Suggestive)
 - Volume of Transaction (Budget and actual amount of expenditure),
 - Complexities involved,
 - Control Environment,
 - Past Experience with audit unit
- Classify audit units for audit purposes
- Consider the coverage of all audit units in specified period of time (Say 3 years)

Managing Audit Units based on RBA



RBA Selection: Example

- As per classification of Audit Units (On the basis of Scoring System used above)

Units	Category A	Category B	Category C
Cover for detailed examinations	all	Certain percentage (say 50%)	Certain percentage (say 1/3 units)
Perform Limited Reviews	NA	For Rest of units which have not been subjected for detailed examination	For Rest of units which have not been subjected for detailed examination

Traditional Audit Vs Risk Based Audit

Traditional Audit	Risk Based Audit
Post Mortem	Forward looking
Testing of transactions (focus on finding errors irrespective of materiality level)	Risk identification & management (focuses on material risk areas and ensures that major controls

	are operating)
Financial Focus	Focus on all areas of operation (e.g. system)
Confirm that internal controls are operating	Provides opinion whether risks are being properly managed

Managing Risks

1. Risk Identification

How to Identify Risk

- Audit risk can be identified through understanding entity; Its environment including internal control and reporting framework.
- This may include understanding of vision, mission, objectives/goals, programmes, Risk management framework used by entities, regulatory framework, monitoring and evaluation system.
- A methodical and planned approach to identify risks, process includes
 - Reviewing Documents
 - Brainstorming
 - Delphi technique

- SWOT
- Interview
- Flowcharts

2. Risk Assessment

How to Assess Risk

- Do you think that any activity/transaction can be free of risk? (Each activity has its objective and some sort of risk is attached with that which may prevent it from achieving objective)
- So, what may go wrong in achieving objective?
- If we identify about what may go wrong, what could be the treatment to address that wrong doing? (design and application of Internal Control System)
- Do you think design of Internal Control System be always appropriate? If yes, can it always be implemented as it was designed? (Control Effectiveness)

Risk Assessment Procedure

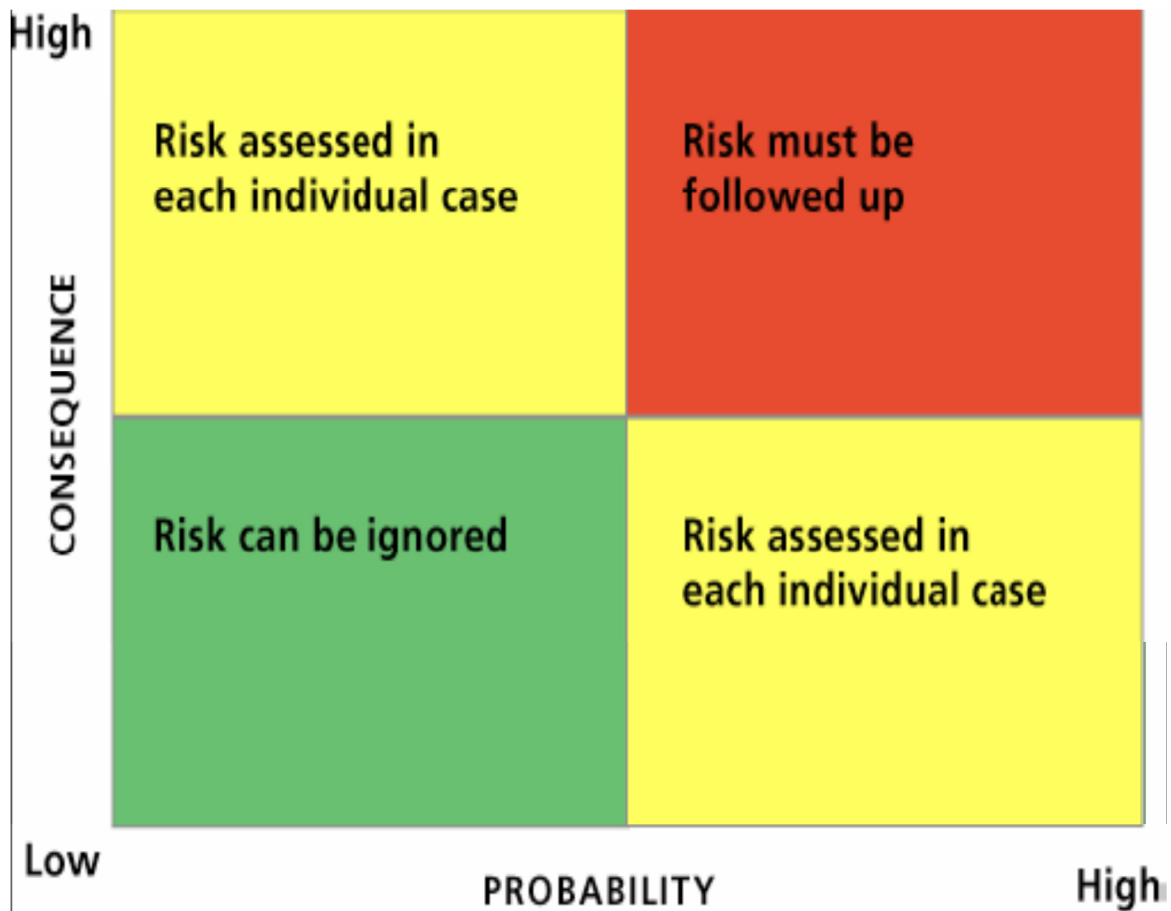
The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- Inquiries (Those Charged with Governance, Internal Auditors, Employees; process owners, Legal advisor, and others)
- Analytical Procedures (Analysis of Financial and Non-financial information; Ratio, Trend and other Analytical Tools)
- Observation and Inspection (Vision, Mission, Strategy, Plan/Programs, Progress Reports, Standard Operating Procedures, Monitoring and Evaluation, onsite observation of operations)

Likelihood of residual risk

Rare (1)	1 Acceptable	2 Acceptable	3 Acceptable	4 Acceptable	5 Supplementary Issue
Unlikely (2)	2 Acceptable	4 Acceptable	6 Supplementary Issue	8 Supplementary Issue	10 Issue
Possible (3)	3 Acceptable	6 Supplementary Issue	9 Issue	12 Issue	15 Unacceptable
Probable (4)	4 Acceptable	8 Supplementary Issue	12 Issue	16 Unacceptable	20 Unacceptable
Almost certain (5)	5 Supplementary Issue	10 Issue	15 Unacceptable	20 Unacceptable	25 Unacceptable
	Insignificant (1)	Minor (2)	Moderate (3)	Major (4)	Catastrophic (5)

3. Risk Response



REACTIONS TO RISK

Avoid (Terminate)	Accept(Tolerate)
Control (Treat)	Insure (Transfer)

4. Risk Monitoring and Control

- Risk Register Updates
- Recommended change requests
- Recommended corrective actions
- Recommended preventive actions
- Risk response plan updates
- Process management plan updates

Hope you find the article useful. Thank you for reading-KB Chitracar & Co, Chartered Accountants