COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | BASIC/INTERMEDIATE

Video Transcription: Business Risk vs Audit Risk

Hi there, my name is Wayne and, in this video, I will be explaining both business and audit risk, how they differ and why understanding them is important to both management and auditors.

Before I cover what a business risk is, what do you understand by the term "risk"?
In simple terminology, a risk is what can go wrong. Imagine you had a look at the weather and you saw that it was very overcast and very cloudy. What can go wrong? There is a risk that it might rain and you may get wet.

So now that we understand what a risk is, what is a business risk? A business risk is what can go wrong in the business.

Business risks can be separated into three categories:

1. What can go wrong in the reporting of financial and non-financial information? This is known as an information reporting risk.
2. What can go wrong in the operations of the business? This is known as an operational risk.
3. What can go wrong in terms of compliance with laws and regulations? This is known as a non-compliance risk.

You may find that a business risk may affect more than one category. For example, a supermarket sells oranges; a few of their oranges on the shelves have gone rotten. What are the business risks? In other words what can go wrong if the oranges are rotten? Are there any financial reporting risks? What could go wrong in the financial statements? Well, there is a risk that the write down of inventory may not be recorded appropriately in the books of the business.

Are there any operational risks? What can go wrong in the operations of the business?

A. There is a risk that the business may not be able to sell the rotten oranges to customers, and therefore the business will lose out on cash that will be generated from selling the oranges.
B. There is a further operational risk that the measures that management has put into place, to ensure that rotten oranges are removed from the shelves and not sold to customers, are not in place or working properly.
C. Customers may not purchase further goods from the supermarket if they find rotten oranges on the shelves.

Are there any non-compliance risks? What can go wrong in terms of non-compliance with laws and regulations? Well, there is a risk that the business may be in breach of consumer protection laws for selling rotten oranges to customers, therefore resulting in fines and penalties, and the possible outflow of cash to settle the fines and penalties.

So why is it important for management to be able to understand business risks? It is important for management to understand business risk so that they can identify business risks, assess the business risk and then respond to the risk. This process is known as risk management. Business risk refers to what can go wrong with a business and needs to be understood and managed by management within the business, to minimise the negative impact on the business.

So, what is audit risk? Auditors are not involved in the management of the companies that they audit. Auditors are external people that express an opinion on whether the annual financial statements prepared by management are fairly presented. In other words, that the financial statements do not contain any material misstatements. This opinion is expressed after performing all the audit procedures. So, audit risk is the risk that an auditor will express the wrong opinion, on the annual financial statements presented by management, of the company being audited

How could an auditor express the wrong opinion? It could be due to inadequate audit procedures being performed by the auditor, or due to false or misleading financial information given by management. So, what type of business risk will an auditor be interested in? All companies face business risks, which could be classified as financial reporting, operating, or compliance risk. Let's look at examples where an auditor will be interested in the business risk.

Let's go back to our supermarket example. Would an auditor be interested in why a company is not generating as much revenue as they can? For instance, if our supermarket is losing customers because they are selling rotten oranges, it is management's job to think of ways to mitigate that operational risk, and it is not the job of the auditor. However, auditors will be interested in the sales that have actually happened, and not those that could have potentially happened, and will inspect if management have recorded these sales, and have recorded them correctly. So, as an auditor, it is not our job to ensure that rotten oranges are not sold, that is management's job.

As auditors, we will also identify that because some of the oranges are rotten, they may not be valued correctly in the annual financial statements. So, we are concerned whether management has written down the rotten oranges to the appropriate value. This is a financial reporting business risk and, if it occurs, could lead to a material misstatement.

Can you see that if we, as auditors, understand the business risks that a company faces, we will be able to determine if that business risk could potentially lead to a risk of misstatement, and we can then design appropriate audit procedures. If we do this, the risk of us passing an incorrect audit opinion will be reduced.

Thank you for watching and I hope this video helped you develop an understanding of the difference between a business risk and an audit risk.