COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | BASIC/INTERMEDIATE

Video Transcription: The Audit Risk Formula

Hello there, my name is Mark, and this video will be addressing a key part of *how* audits actually take place – the Audit Risk Formula.

So, what is the goal of an audit? It is to indicate to people who use financial statements whether the financial statements are fairly presented and free of material misstatement. This is referred to as the auditor's opinion on the financial statements. But, how do auditors reach this conclusion? In other words, that the financial statements are fairly presented and free of material misstatement when it is impossible to test every single number and disclosure included in the financial statements.

Remember, as an auditor, the worst thing that could happen is to say that a set of financial statements are free from material misstatement when they are, in fact, not. The risk that this never happens can only be addressed by testing every transaction and disclosure in the financial statements. However, as this is impossible to do, auditors are willing to accept a reasonable amount of risk that an incorrect opinion is given. This risk is referred to as Audit Risk.

So, Audit Risk is the risk that an auditor may give the users of financial statements an incorrect opinion, stating that the financial statements contain no material misstatements.

Audit Risk (AR) is a function of:
1. How risky is the actual number or particular disclosure in the financial statements? For example, a provision, as a result of a lawsuit, is inherently more risky than a normal debtors balance. This is called Inherent Risk because it is a risk that is inherent in the account as a result of the type of account.

2. How good management is at ensuring that transactions entering the general ledger are valid, accurate and complete. Management is able to make sure that all transactions are valid, accurate and complete by putting controls in place. This component of Audit Risk is therefore called Control Risk. If there are no such controls then this risk is high.

3. Whether we test enough to make sure there are no material errors in a particular account or disclosure. This is called Detection Risk, because it is the risk that we test and don't find a material misstatement when there is one. If we test a lot of transactions within an account, we would be less worried that there would be an error. If we test very few transactions we run the risk of not finding a material error.

Audit risk can therefore be described as a combination of Inherent Risk, Control Risk and Detection Risk. When we accept an audit client we will assess the amount of audit risk that is acceptable, with respect to the particular client. The amount of risk accepted with respect to the client cannot change during the audit process.

So, let's think of Audit Risk as a glass of water. A full glass of water equals the total Audit Risk we can accept, in other words, the amount determined before the start of the audit. If you fill the glass and it spills over, the Audit Risk has become too high; in other words, the chance that we would indicate that there is no material misstatement when in fact there are, is too high.

Let's look at two scenarios. In scenario one, the glass is full but not spilt over. This means that the level of Inherent Risk, Control Risk and Detection Risk together are appropriate for the auditors to say that an amount or disclosure is not materially misstated. In the second scenario the water in the glass has spilt over. This means that the combination of Inherent Risk, Control Risk and Detection Risk is too risky to conclude that the amount or disclosure is not materially misstated.

How do we solve this problem? Given that the acceptable audit risk has already been determined, and cannot change, we have to look to the components that cause the glass to fill up. In other words, we have to reduce the overall level of risk by lowering one of the risk components of Audit Risk. For example, if we had to decrease the Detection Risk of the second glass, overall the water in the glass would not be spilt.

Could we choose to lower the other two risk components of Audit Risk, namely the Inherent or Control Risk, to bring the water level in the glass down? Well, no. As we said earlier, Inherent Risk is dependent on the nature of the amount of disclosure. Some numbers in the financial statements are simply riskier than others. There is nothing the auditor can do to influence this risk.

Control Risk depends on whether management have actually put controls in place to ensure that all numbers are valid, accurate and complete. If they have, and we test the fact that they have controls, Control Risk will be low. If not, it will be high. Control Risk is unusual in that there will either be or not be controls in place. It's a yes or no scenario, not a question of how much. However, if you want the Control Risk to be a smaller portion of the total glass of Audit Risk, you have to test the controls.

We can therefore see that the only part of Audit Risk that the auditor can influence is Detection Risk. If we tested every transaction in a particular account, we could bring Detection Risk to zero, if we don't test any transactions within an account, the Detection Risk would be very high.

Let's look at an example. In the video is the statement of financial position of Hypothetical (Pty) Ltd. Let's look at the bank line item. Remember that as auditors we need to test bank to make sure it exists, that it is complete, that it is valued correctly. However, for this example we are only going to focus on the process to ensure that bank actually exists. After reveiwing the trial balance we identify that the bank amounts consists of two bank accounts that the business has opened at two local, large commercial banks, that together have a balance of R200.

As there are only two bank accounts, both opened at large commercial banks, we would probably conclude that the existence of the bank line item is inherently low risk. If there were hundreds of bank accounts opened at many different banks, we may conclude that the bank line item was inherently risky.

After further investigation, you identify several controls that management has created with respect to the bank line item. A staff member prepares daily bank reconciliations, which are reviewed by management and all parties sign the reconciliations to highlight that they have completed their part of the process. You decide to test the bank reconciliation control and conclude that the control does support the fact that the bank balances do exist. Because there are controls and you have tested the control you rate control risk as low.

With respect to the bank line item, both the inherent and control risks are fairly low, in other words, the glass is not very full. This means that we can accept a higher amount of detection risk. Our procedure to make sure the bank balance exists is to confirm this directly with the two banks. Given that we can accept a larger amount of Detection Risk, we may only confirm one of the two bank accounts.

If, for example, no bank reconciliation was prepared, there would be no control for us to test. The Inherent Risk would not have changed. The control risk would now be a larger portion of our glass. To lower the Detection Risk, we would test both bank accounts. We would, therefore, have no Detection Risk since we have tested that the whole bank balance exists.

So, auditors accept a certain amount of Audit Risk when concluding that a set of financial statements is free from material misstatement. Audit Risk is a function of the Inherent Risk of a given account, the controls in place and lastly of how much of an account we test. For the specified amount of audit risk, the auditor can only influence Detection Risk to bring total Audit Risk within that allowed amount. Overall risk is therefore lowered by testing more of an account and increased by testing less of an account.

Thank you so much for watching.