COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | ADVANCED

Video Transcription: Risk of Material Misstatement: Part 1

Hello, everyone. The purpose of this video is to discuss risk of material misstatement in terms of ISA315 (Revised), so I encourage you to do at least two things:

1. One is to watch the video that deals with audit risk: What is audit risk, inherent risk, control risk and detection risk; and

2. Two – to have ISA315 (Revised) open in front of you as you listen to this video.

So what is ISA315 (Revised) talking about? It's talking about the auditor's objective of identifying and assessing the risk of material misstatement due to fraud and error at both the assertion level and the financial statement level. Remember that all audit is, is really an identification of the various kinds of risks and material misstatement in the financial statements, and then designing appropriate responses to those risks, and then reporting on the results of those responses.

So, what we're going to do now is look at some of the definitions in ISA315. ISA315 talks about risk of material misstatement, and we know that audit risk is a function of risk and material misstatement and detection risk. So if you remember the audit risk equation: audit risk = inherent risk x control risk x detection risk (and the combination of inherent risk and control risk is your risk of material misstatement). What I'd like to highlight are the different levels and components of the risk of material misstatement assessment. If you have a look in ISA315, you'll see that it says the objective of the auditor is first to identify the risks of material misstatement, then to assess their significance at both the financial statement level and the assertion level for fraud and error.

So a distinction I'd like to make at the beginning is the difference between risk of material misstatement and detection risk. Risk of material misstatement is not a type of risk that the auditor has any control over. The inherent risk is inherent in the business. Control risks are risks that the controls are not reducing risk to an appropriate level. Note that both these two types of audit risk are the responsibility of management, not the auditor, so all the auditor does is assess their level at the client. Detection risk is different. Detection risk comes down as the auditor does more audit procedures. So can you see that the auditor identifies and assesses the level of the risk of material misstatement, which is inherent risk and control risk, but they actually design their own procedures to reduce detection risk down so that the combination of risk of material misstatement and detection risk brings the audit risk of the client down to an appropriate level.

Now what we're going to talk about is the three components of the objective of a risk of material misstatement:

1. One is identify and assess risk of material misstatement;

2. Two is do it at an assertion level and at a financial statement level; and

3. Three is make sure that you assess fraud risks and risk of error separately

So what's the difference between identifying a risk and assessing the significance of the risk? When you identify a risk, you're simply saying that this risk exists, and then you take factors from the scenario, factors from the client, to justify that risk. That's simply identifying the risk. So, I'd like you to see a distinction between identifying the risk, which is simply explaining the risks that are there using the facts from the scenario, and assessing the significance of the risk.

So what is assessing the significance of a risk? Once a risk is down, once you've seen that there's a risk and you've described it, you then decide: "Is that risk low, or moderate, or high for this client?" Can you see the distinction? Identifying the risk and justifying the facts from the scenario as to why that risk is there, using risk factors from the scenario. What's a risk factor? It's simply a fact that leads you to believe that that risk exists. That's identifying the risk. Assessing the risk is a simple exercise of applying your mind to that identified risk and assessing: "Is this a significant risk or not? What is the degree of the significance? Is it a low, moderate or high degree of significance?"

The next aspect is the two levels. Is it a risk at a financial statement level, or a risk at an assertion level? So let's discuss that. What is a financial statement level risk? A financial statement level risk is defined as a risk that is pervasive throughout the financial statements. It is throughout trial balance pervasively. So if you have a risk that affects a number of accounts and therefore a number of assertions, such as: a going concern risk, such as if risk complexity, accounting complexity in a production of the trial balance, such as incentive for management to overstate profits or financial position, or a fraud risk that might lead management to overstate profits, any factor that makes you believe management has an incentive to overstate profits or financial position (such as they are awarded performance bonuses, such as the company is a listed entity and there's incentive to manipulate the share price). All these risks that I've just described clearly affect the financial statements as a whole.

How do you overstate a profit? How do you overstate financial position? Well, you could overstate any income and understate any expense. You could overstate any asset and understate any liability. By doing any of those, you would overstate profit or financial position, so you can see how those risks are pervasive through the financial statement. What about going concern risk? If there's uncertainty about the ability of the company to operate as a going concern in the next 12 months, that is a risk throughout the financial statements because the entirety of IFRS is based on the assumption that the company is a going concern. Can you see that all those risks I've mentioned are financial statement level risks? They're pervasive throughout the financial statements.

So what is an assertion level risk? Well, an assertion level risk is mutually exclusive to a financial statement level risk. It affects only a small group of accounts or assertions. It's limited; it's not pervasive through the financial statements. For example, if there's a risk of duplication of sales transactions (risk factor: there's a large volume of transactions, therefore there's that risk of it being duplicated). That's an occurrence risk to revenue. Can you see how that risk and the factors that justify that risk affected only revenue? Don't make the mistake of thinking that simply because one risk affects two accounts that it's all of a sudden a financial statement level risk. That doesn't really make sense when you think that double entry and the accounting equation require every transaction to affect two accounts.

A financial statement level risk is one that clearly is pervasive. An assertion level risk only affects a small group of classes of transactions, account balances, and presentations and disclosures. It's usually, if you're in doubt as to whether it's a financial statement level risk or an assertion level risk, it's usually an indication that it's an assertion level risk, because you're in doubt as to how far it pervades throughout the financial statements.

And the final aspect of a risk of material misstatement assessment: we've already discussed identify versus assessing the risk of material misstatement; secondly, we talked about identifying risks for material misstatement at a financial statement level and an assertion level; now, the third aspect is make sure that you apply your mind separately to the risks of fraud and error.

ISA315 mostly speaks to the risk of error, and ISA240 speaks to the risk of fraud. What is the difference between fraud and error? Well, it's quite clear – fraud is a deliberate, intentional act to misstate the financial statements. If it's deliberate, not by mistake, then it's fraud. And I'm sure it stands to reason that fraud risks for the auditor are harder to detect, because if management is committing fraud, they have usually taken active steps to conceal it. So more professional scepticism is needed by the auditor with respect to fraud risks.

And finally for this part of the video, I'd just like to highlight some tips for answering a risk of material misstatement question.

First tip: make sure you understand how the question has been asked. Are they asking you for inherent risks, or are they asking you for control risks? Or, are they asking you for risks of material misstatement (which would be both inherent risk and control risk)? Is the required asking you just to identify the risk (in which case you describe the risk, plus all the risk factors from the scenario that lead you to believe that that's a risk). Or, did the question ask you to identify and assess the risks of material misstatement? Assessing means that in your answer you've got to apply your mind as to the significance – low, moderate or high – of that risk. Did they ask it at a financial statement level or an assertion level? Did they exclude error or exclude fraud? If they didn't say either, they're including both error and fraud in the scope of the question. Make sure you understand the required.

Just a note – inherent risks and control risks are mutually exclusive risks. There is no overlap between inherent risks and control risks by definition, so please have a look at the definition of inherent risk, which has at the end of the definition “without considering the controls that might be there”. You do not apply your mind to any controls when describing an inherent risk. And with a control risk, which we’re going to talk about in the second video, you only talk about controls. So can you see inherent risks and control risks are mutually exclusive? But of course if the question asks you for risks of material misstatement, they’re asking you to apply your mind to the inherent risks that are there and the control risks that are there.

Second tip: remember with inherent risks that you must state the risk and use risk factors to justify your risks. In a risk assessment question there are more marks awarded for putting the facts from the scenario into your answer to justify the risks that you’ve stated. For example: “There’s a risk that property plant and equipment may not exist”. Why? Your “why” is the factors from the scenario and each of them get you marks, so don’t forget the risk factors.

A third tip when answering a risk assessment question is: always think in terms of assertions. It’s so important to think in terms of assertions because the risk assessment is driven by the assertions. What are financial statement level risks? Risks that affect all assertions. What are assertion level risks? Risks that affect account balances (and we know that assertions attach themselves to accounts, so the whole risk assessment process is assertion driven). And risk response, when you do procedures to address those risks, are also assertion driven.

Fourth tip: your fourth tip is when you’re given an account to do a risk assessment, or when you’re considering a certain account, always think about where the most significant risks lie. For example, if it’s an intangible asset, it’s in the valuation of that intangible asset, because IAS38 has a lot to do, has a lot to say about how you value an intangible asset. If it’s revenue, what’s the most significant risk for revenue? It’s occurrence; occurrence due to fraud, occurrence due to error. The risks around occurrence are the most significant risk assertion for revenue.

What about accrued expenses? Apply your mind now. What do you think would be the most significant risk assertion for accrued expenses? Well, by mistake they might not have included all the accrued expenses at year end, or they’ve actually got a fraud risk incentive to exclude some expenses from the income statement at year end. Can you see that completeness is your most significant risk assertion? So what is the fourth tip? Always think: “The most significant risk for this account are the risks that are going to award me with the most marks in my answer”.

Great. So thank you for watching part one to risk of material misstatement – how do we assess risks of material misstatement?

Make sure that you watch part two where we’re going to be discussing inherent risk and control risk in slightly more detail.