COLLEGE OF ACCOUNTING

AUDITING/CORPORATE GOVERNANCE | ADVANCED

Video Transcription: Risk of Material Misstatement: Part 2

Hello, everyone. This is part two of the Risk of Material Misstatement videos. Please have ISA315 (Revised) open in front of you so that you can see that this video is really explaining the terms, concepts, and principles that are in ISA315.

So, what is a risk of material misstatement? It's the risk that the financial statements may be materially misstated due to fraud or error, and that risk sits in inherent risks or control risks.

So I would like to start off with a quick definition of an inherent risk and a control risk. An inherent risk and a control risk are mutually exclusive concepts – by definition they are mutually exclusive. There is no such thing as a risk that is both an inherent and a control risk, and I'll explain why by the definitions.

An inherent risk is an assertion risk – a risk to the assertions, for a class of transactions, an account balance, or presentation and disclosure in the financial statements, without or before considering any controls. Obviously, there may be controls present, but the auditor doesn't consider those controls, and they simply look at the risks that are inherently there – hence the term inherent risk – before considering any controls.

You can see that the very definition of an inherent risk is a warning to you never to discuss anything about a control, a deficient control, or controls that should be there, because that is excluded from the definition of an inherent risk.

So what is a control risk? A control risk is the risk to a class of transaction, account balance, or presentation and disclosure that will not be detected, corrected, or prevented based on controls that are present at the entity. So can you see – you have a certain level of inherent risk before considering controls. And if there are controls, it will have an effect of lowering that inherent risk, that is ROMM – risk of material misstatement.

So you could think of controls as the net against inherent risk. You've got inherent risks – management's responsibility is to implement controls. And, obviously, controls are preventing the inherent risks from resulting in a risk of material misstatement. When you consider the inherent risk, and the net (which is the controls), the combination of the two is risk of material misstatement. So a control risk is a risk that is to the material misstatement of the financial statements. All risks are to the material misstatement of the financial statements, but a control risk has got to do with the inability of a control to reduce risk of material misstatement.

How do you answer a control risk assessment question? Here's a required: "Based on working paper X, perform a control risk assessment". So, first thing is if, in that working paper X, there happen to be controls in that cycle, do you agree that those controls will reduce the risk of material misstatement? So if you are asked to do a control risk assessment based on a cycle in working paper X, you simply go to working paper X and you identify all the controls that are present. Part of assessing control risk is identifying controls that are present in the scenario.

So, at this point I want to make a distinction. When the auditor arrives at the client, they assume inherent risk is zero, because they need evidence by understanding the entity, understanding the processes, understanding the accounting, understanding the financial reporting and all the transactions that have happened in the company, before they can build up their inherent risk assessment.

They need evidence that the risks are present. They need to see the risk factors on an assertion level and on a financial statement level. So can you see how you build up your inherent risks from the bottom up? But with a control risk assessment, when the auditor arrives at the client, they do something slightly different. They assume control risk is 100%, not 0%.

Can you see how inherent risk is assumed to be zero until evidence brings the inherent risk assessment up, but control risk starts as high as possible, because the auditor has to assume that there are no controls, until they've got evidence that controls are in place to address those inherent risks? So the auditor does the inherent risk assessment first, and control risk assessment second, because you're looking for controls that are put in place by management to address those inherent risks that you've found. But it works in opposite directions. So, as the auditor gets evidence that there are controls through assessing the design of controls and identifying controls that are there in the scenario, as we've just discussed, the control risk assessment comes down. The inherent risk assessment is going up. Can you see the difference of directions? When they multiply together, that's risk of material misstatement. So, as controls are found in the client, the auditor has reason to reduce their control risk assessment.

How do they reduce their control risk assessment? They identify the design of controls that are present at the entity, then what they do... It's not good enough to just a see a piece of paper and say there are controls present. What the auditor then goes and does is test the controls. There are two ways in which an auditor tests controls. The first way is that they test the controls for implementation. Testing for implementation is a step beyond identifying the controls. Identifying the controls is assessing design. Are the controls designed? How do I know that? I read the system's description on a piece of paper (management's given me that system's description). If I see key controls, I can lower my control risk assessment, but all I'm doing is assessing design.

Now I go a step further. I'm answering the question: "Are those controls implemented in the cycle? Implemented at the client? Implemented in the business?" How do you do that? You assess implementation. You test for implementation. That's often called a walkthrough test. You take one, or two, or three transactions at the most, and you go and look at how those transactions, which have already been processed in, say, the revenue cycle, and you go and test that all the controls that are supposed to prevent, detect, or correct fraud or error on those one, or two, or three transactions have been working appropriately. I'm sure you agree, if you find that that simple implementation test, which we call a walkthrough, if that fails, if you find, for those one, two, or three transactions, that the controls were not doing what they were supposed to, then there's no need to do the third type of control test, which is testing for operating effectiveness.

The testing for operating effectiveness is the type of test that you have always done as an answer to the question: test the controls. When the auditor tests the controls, we are really meaning test the controls for operating effectiveness.

So let's get back to the risk of material misstatement assessment. For control risk, what you're doing is answering the question: "Are the controls there, and have they been implemented?" So, when you get the question: "Assess the control risk in working paper X", the first step is design. That's going and looking and seeing what controls are there. And then this is what you say for design:

"The following controls reduce control risk:

1. This control;
2. This control;
3. This control; and
4. This control."

Note what I did. All I did was identify the key controls in the scenario and put them down on my paper. You're thinking: "Is that not just an 'identify key controls' question?" Yes. The first step in a control risk assessment is simply identifying the key controls. So you go and write: "The following controls reduce control risk". Remember, they reduce control risk – inherent risk goes up; control risk comes down with controls. So:

"The following reduce control risk:

1. This control;
2. This control;
3. This control; and
4. This control."

Now, you usually end there because, in the question, you're not asked to assess implementation, and you're certainly not asked to test controls. But, theoretically, how does the auditor finish the control risk assessment? They have got to assess design, test implementation, and, if they are taking a combined approach for that account, they will then test those controls which they have found to be implemented - they'll test those controls for operating effectiveness. Design, implementation, operating effectiveness.

Please note that you only test for operating effectiveness if you have decided to take the audit approach, which we call a combined approach, for that account. So sometimes your risk assessment will just consist of assessing design and implementation, because you've decided not to take a combined approach - you've decided to take a substantive approach. Substantive approach only tests substantively; a combined approach tests substantively after having tested the controls for operating effectiveness.

So when you are reading: "test controls", always think: "that usually means test the controls for operating effectiveness". But in a control risk assessment, you are doing a test for design and implementation before making the decision to test the controls for operating effectiveness.

Please always remember that it's the responsibility of management to implement controls, and that's why, when you do your "control testing" – remember, control testing could either be assessing the design, which is identifying the key controls that are there, or assessing implementation (testing implementation through a walkthrough test), but most of the time it is testing the controls for operating effectiveness – if you find any deficient controls, you are required, in terms of the International Standards on Auditing, to report those control deficiencies to management. That's part of the value-added process of doing a report. In addition to the audit opinion, you are telling management, you're telling those charged with governance, that we tested controls in these areas, and these are the deficiencies or inefficiencies that we've found.

So, to end off this video, I'd like to present a basic scenario. Let's say working paper X has a revenue cycle description. There are inherent risks to revenue in working paper X but, and this is important, there are also controls in that system's description, in working paper X. Now the question asks you: "Identify the risks of material misstatement to revenue, based on working paper X".

So you think immediately: "It's risk of material misstatement – I need to do an inherent risk assessment". Not quite. I need to identify inherent risks. Identifying inherent risks is separate from following on to assessing their significance. The required asked: "Identify the risks of material misstatement".

So, inherent risks – I'm going to identify them and provide all my reasoning, the risk factors from working paper X, that lead me to believe that those inherent risks exist. That's my inherent risk part of my answer - no reference to controls in that part of my answer. But, they asked risk of material misstatement, so a second part of my answer has got to be identifying the controls that are there in working paper X. Yes, it's part of your risk assessment to identify the controls.

So I will say: “The following controls identified reduced control risk”. And, of course, if it reduces control risk, it reduces risk of material misstatement, because IR x CR is risk of material misstatement. So now the other part of my answer is simply identifying the key controls over revenue that are in working paper X. Now, you might ask yourself: “What happens if there is an obvious deficient control in working paper X?”. Well, deficient controls increase your control risk assessment, and controls that are present decrease control risk. So, usually, your answer will be:
“The following controls decrease control risk:

1. This control;
2. This control; and
3. This control.

Then you can say: “This control and this control’s deficient for this reason and this reason” (because it’s been described as being deficient), and that has the effect of increasing your control risk assessment. That’s the harder part of the question. Students often treat a risk of material misstatement question as just an inherent risk question. But, if there are controls that are present, you will get marks for saying: “The following controls that are present reduce control risk”.

So that is the end of part two. What have we covered in part one and two? We’ve just discussed a conceptual understanding of how the auditor does a risk of material misstatement assessment in different circumstances.