

RISK MANAGEMENT PRACTICES IN AUDIT

Presentation by:

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Agenda



S1: Standards on Audit Risk

S2: Understanding Audit Risk

S3: Human Resource concerns and
Audit risk

S1: Developing an Audit Risk Model

IAS 300/AS1101 (PCAOB)



- IAS 315 Assessing risk of material misstatement applies broadly for the audit of financial statements.
- AS 1101 (PCAOB) Provide guidance for assessing and determining the risk of material misstatement (and audit risk) in financial statement under SEC.
- AS2110 Identifying and Assessing Risks of Material Misstatement.

Audit Risk Defined



What is Audit Risk?

- Audit risk is the risk that the auditors may give an inappropriate opinion when the financial statements are materially misstated.
- Within internal audit it's the risk of giving an erroneous opinion on the status of the Organization's internal control environment.

Audit Risk Defined



- ❑ AS 1101: "To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence."

Audit Risk Defined



- ❑ AS 2110, *Identifying and Assessing Risks of Material Misstatement*, indicates that the auditor should assess the risks of material misstatement at two levels:
 - (1) at the financial statement level and
 - (2) at the assertion level.
- ❑ Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions.

Audit Risk Defined



- ❑ Risk of material misstatement at the assertion level consists of the following components:
 - Inherent risk, which refers to the **susceptibility of an assertion** to a misstatement, due to error or fraud, that could be material, individually or in combination with other misstatements, before consideration of any related controls.

Audit Risk Defined



- Control risk, which is the risk that a misstatement due to error or fraud that could occur in an assertion and that could be material, individually or in combination with other misstatements, will not be prevented or detected on a timely basis by the company's internal control. Control risk is a function of the effectiveness of the design and operation of internal control.

Audit Risk Defined



□ Audit Risk = Inherent Risk x Control Risk x Detection Risk

Financial Statement Assertions



- ❑ Existence or occurrence—Assets or liabilities of the company exist at a given date, and recorded transactions have occurred during a given period.
- ❑ Completeness—All transactions and accounts that should be presented in the financial statements are so included.
- ❑ Valuation or allocation—Asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts.

Financial Statement Assertions...



- ❑ Rights and obligations—The company holds or controls rights to the assets, and liabilities are obligations of the company at a given date.
- ❑ Presentation and disclosure—The components of the financial statements are properly classified, described, and disclosed.

Audit Evidence



- ☐ Sufficient
 - The higher the risk the greater the quantity of evidence required
- ☐ Appropriate
 - relevant and reliable
- ☐ Relevance and
 - Related to assertion being tested
- ☐ Reliability
 - Independent sources
 - Obtained directly
 - From original documents

Internal Controls



The auditor is required to assess the following with regards to a Company Internal Control framework:

1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring



COSO

Control Environment



- ❑ The auditor should obtain an understanding of the company's control environment, including the policies and actions of management, the board, and the audit committee concerning the company's control environment.

Risk Management



- ❑ Obtaining an understanding of the company's risk assessment process includes obtaining an understanding of the risks of material misstatement identified and assessed by management and the actions taken to address those risks.

Interdependence between Audit & Risk



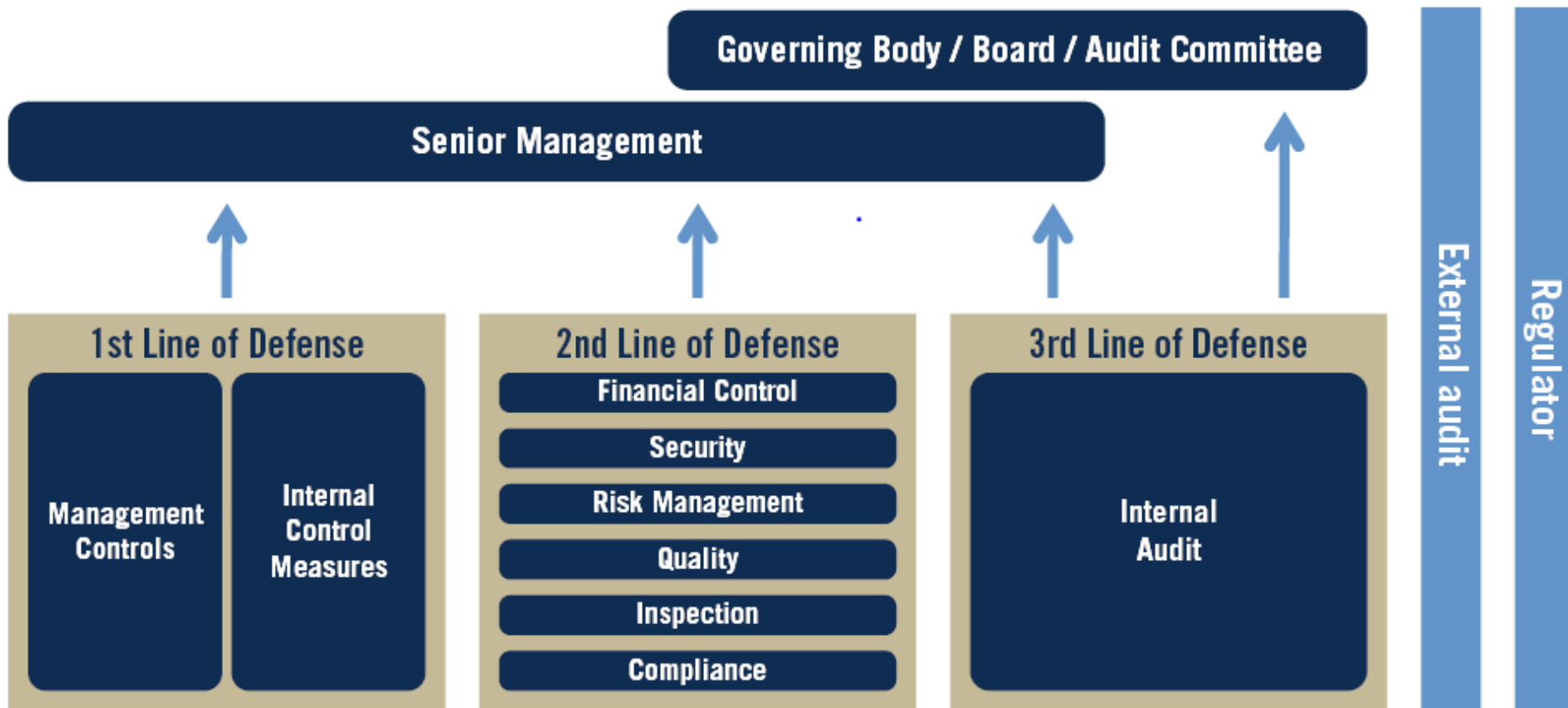
Three lines of defence

1st line	2nd line	3rd line
Line Management	Risk Management & Internal Control	Internal Audit
Manage risks on a daily basis and provide assurance regarding the effectiveness of controls	Steer, monitor and support Line Management at managing risks and providing assurance	Provide additional assurance regarding the effectiveness of controls

Interdependence between Audit & Risk



The Three Lines of Defense Model



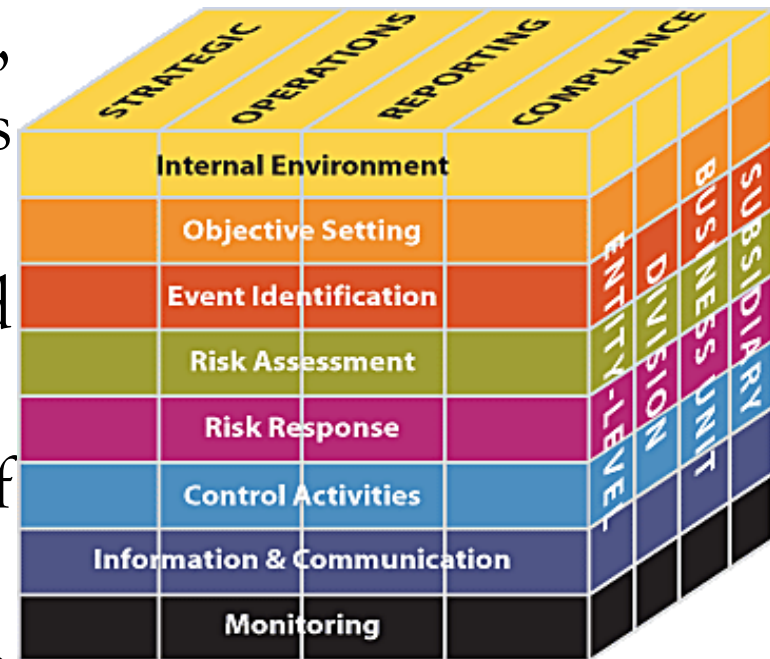
Adapted from ECIIA/FERMA *Guidance on the 8th EU Company Law Directive, article 41*

Enterprise Risk Management



This enterprise risk management framework includes four categories:

1. Strategic: high-level goals, aligned with and supporting its mission
2. Operations: effective and efficient use of its resources
3. Reporting: reliability of reporting
4. Compliance: compliance with applicable laws and regulations



Source: COSO

ISO 31000 ERMF

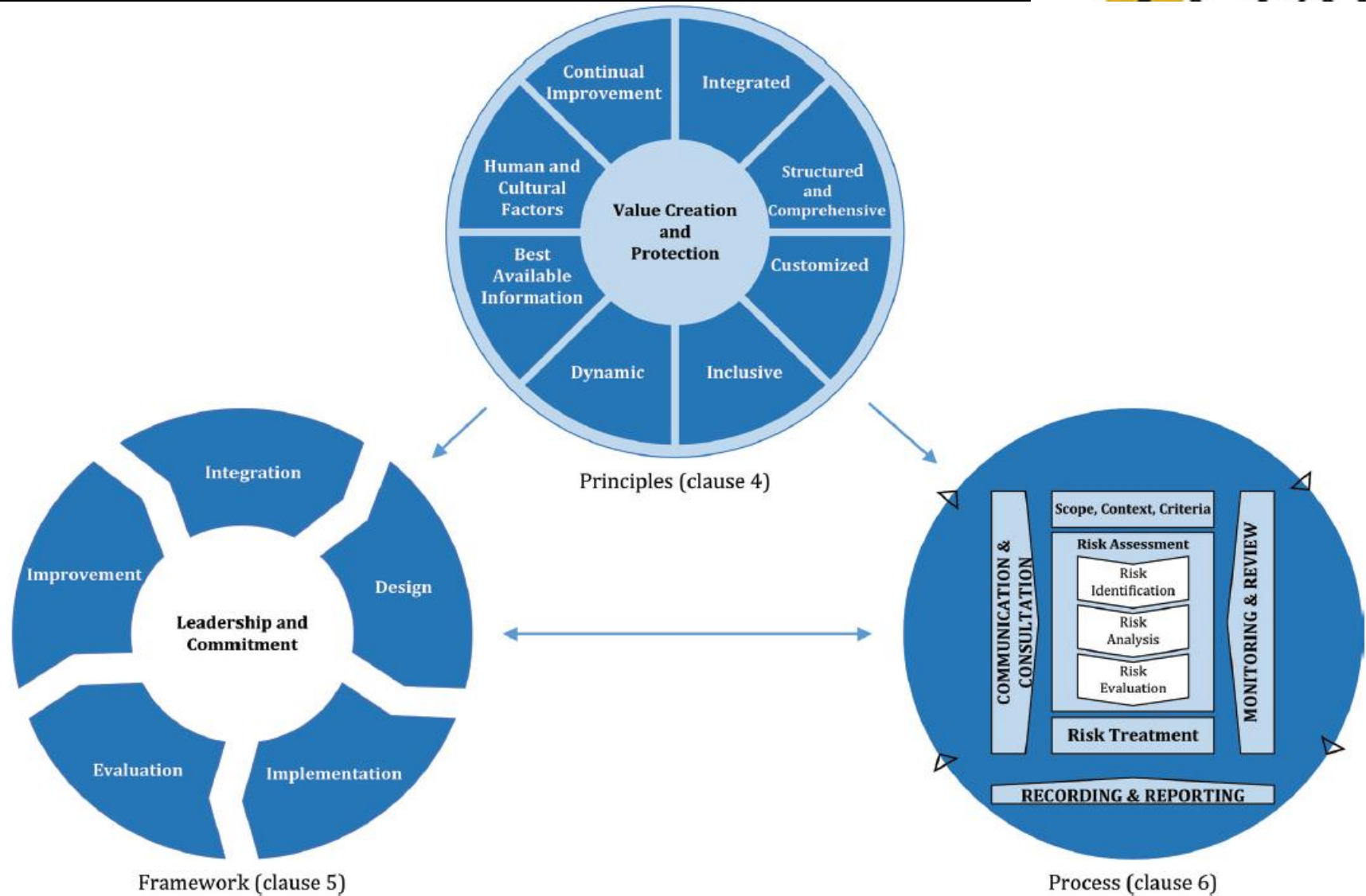


Figure 1 — Principles, framework and process

Information & Communication



The auditor should obtain an understanding of the information system, including the related business processes, relevant to financial reporting.

The auditor should obtain an understanding of how the company communicates financial reporting roles and responsibilities and significant matters relating to financial reporting to relevant company personnel and others, both internally and externally.

Control Activities



- ❑ The auditor should obtain an understanding of control activities that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures.
- ❑ Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Monitoring



The auditor should obtain an understanding of the major types of activities that the company uses to monitor the effectiveness of its internal control over financial reporting and how the company initiates corrective actions related to its controls.

Audit Risk Modeling



Audit risk model

The audit risk model determines the total amount of risk associated with an audit, and describes how this risk can be managed. The calculation is:

Audit risk = Control risk x Detection risk x Inherent risk

Audit Risk Modeling



These elements of the audit risk model are:

Control risk. This risk is caused by the failure of existing controls or the absence of controls, leading to incorrect financial statements.

Detection risk. This risk is caused by the failure of the auditor to discover a material misstatement in the financial statements.

Inherent risk. This risk is caused by an error or omission arising from factors other than control failures.

Audit Risk Modeling



- This (inherent) risk is most common when accounting transactions are quite complex, there is a high degree of judgment involved in accounting for transactions, or the training level of the accounting staff is low.
- When planning an audit engagement, the auditor must review each of the subsidiary levels of risk to determine the total amount of audit risk. If the risk level is too high, the auditor conducts additional procedures to reduce the risk to an acceptable level.

Audit Risk Modeling



- When the level of control risk and inherent risk is high, the auditor can increase the sample size for audit testing, thereby reducing detection risk.
- Conversely, when control risk and inherent risk are considered to be low, it is safe for the auditor to reduce the sample size for auditing testing, which increases detection risk.

Causes of Control Risk



Causes

1. Management overrides
2. Absent controls
3. Weak control activities
4. Training level of the accounting staff is low
5. Fraud concerns
6. Control mismatch/misalignment

Causes of Detection Risk



Causes

1. Inadequate methodology, procedures and tools
2. Audit team capability and capacity
3. Lack of due professional care
4. Insufficient audit evidence



Causes of Inherent Risk



Causes

1. New area of audit
2. Complex operations
3. Organization culture – family owned business/star CEO
4. High degree of judgment involved in accounting for transactions
5. Lack of rotation of audit teams – blind spots

Testing for Control Risk



Testing...

1. Process walkthrough
2. Test of controls (Random sampling)
3. Analytical procedures
4. Observations and discussions with Management
5. Review reported control lapses, customer complaints, Fraud, regulatory sanctions/fines, journals

Testing for Detection Risk



Testing

1. Assess and understand significant changes in:
 - a) Products and services
 - b) Regulation/law
2. Assess and understand degree of subjectivity/judgement used in preparation of financial statements.
3. Process walk through & test of controls
4. Assess the team competences (papers, experience, exposure)

Testing for Inherent Risk



Testing

1. Check for new product and services and their complexity.
2. Check for significant changes in laws, standards, regulations.
3. Test for inherent weaknesses in financial statements.
4. Team brainstorming of Organization culture
5. Develop a model to rate inherent risk on a scale.

Audit Risk & HR



Elements of Staff HR Capacity to consider:

1. Staff engagement
2. Organization Culture
3. Staff overall competence
4. “Techno how”
5. Level of Organization automation
6. Productivity
7. Governance – ‘the star CEO’



Risk Rating Model



Testing for Inherent Risk

Scale 1-5 where 1 is very low and 5 is very high

Existence scale 0 or 1

	Degree - A	Professional Paper -B	Years of experience -C	Exposure - D
Staff 1	0	1	2	1
Staff 2	1	0	3	1
Staff 2	1	1	4	4
Total	2	2	9	6
Average	0.67	0.67	3 (60%)	2(40%)

$$\text{Total score} = \frac{(A+B+C+D)}{4} = 58.5\%$$

Risk Rating Model

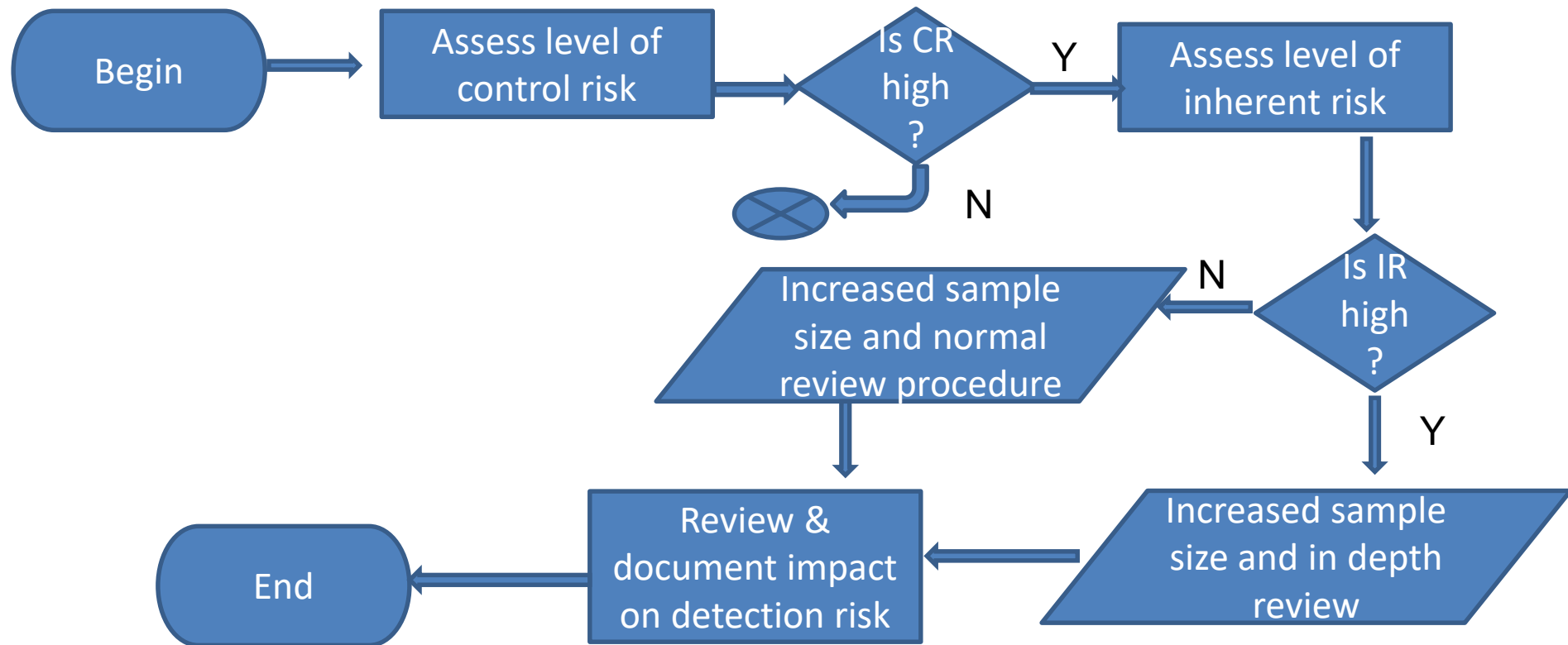


Case in point: calculating audit risk

Audit Risk Model



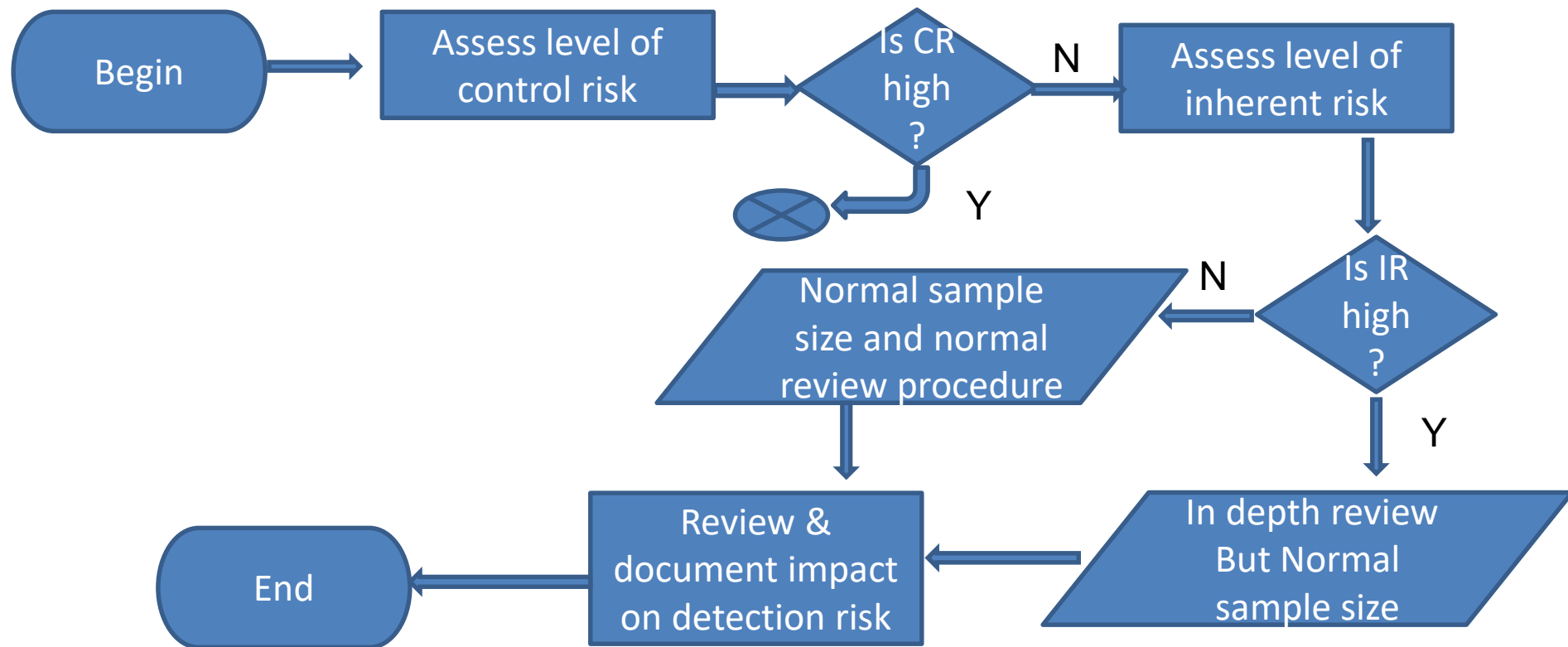
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Audit Risk Model



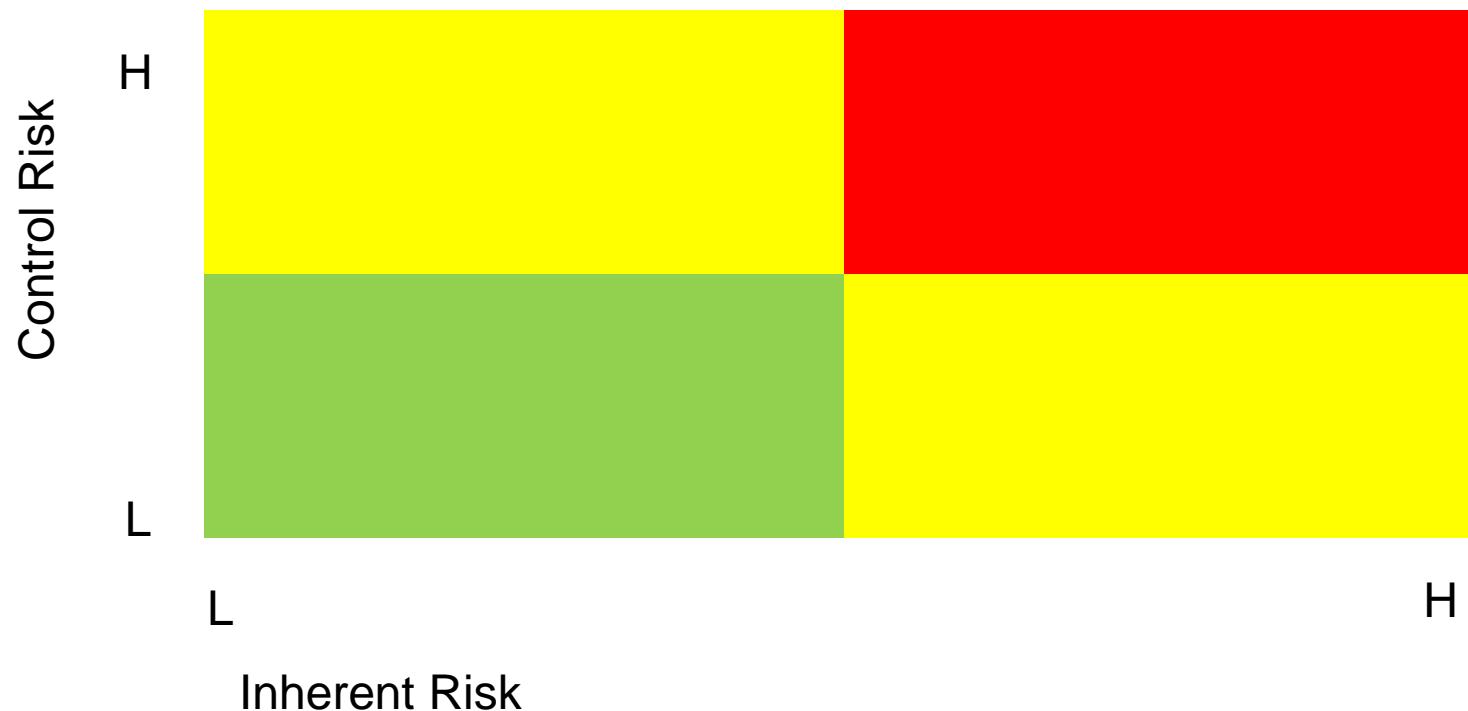
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Audit Risk Model



Audit risk = Control risk x Detection risk x Inherent risk



Audit Risk Model



Control Risk	H	Increase sample size Normal review Moderate detection risk	Increase sample size In-depth review Costly and time consuming Low detection risk
	L	Low sample size Normal review High detection risk	In-depth Review Low Sample Size Moderate detection risk
		L	H
		Inherent Risk	

Audit Risk Model



Control Risk	H	Moderate detection risk	Low detection risk
	L	High detection risk	Moderate detection risk
		L	H
		Inherent Risk	

Detection Risk rules



Rules

1. Random sampling
2. Control sample
3. Employ team brainstorming
4. Quality review by Partner/senior
5. Team peer review



Inherent Risk rules



Rules

1. Reliance on the work of experts in complex areas
2. Spend time on research and insights into new areas
3. Quality review by Partner/senior

Recap



Remember

1. Always testing for audit risk
2. Developing an appropriate audit risk model
3. Scan the clients environment & culture

Case Study



Case Study



From the case study:

1. Identify Control risks
2. Identify Inherent risks
3. What was the Organizational culture like?
4. What procedures would you employ to deal with the risks?

