Risk in Auditing – Inherent Risk

(Relevant to PBE Paper III – Auditing and Information Systems and AAT Examination Paper 8 – Principles of Auditing and Management Information Systems)

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Introduction

There is a close relationship between materiality and risk. Materiality in relation to auditing is considering the magnitude of a misstatement of accounting information that may influence a reasonable decision maker relying on the information to an extent that he or she may change his or her mind. Risk is any level of uncertainty that auditors accept while performing any audit procedures. The risk of material misstatement is an important consideration in auditing. This risk includes inherent risk and control risk.

Candidates are expected to have a basic understanding of inherent risk. This article explains the definition of risk in auditing, the relationship among audit risk elements, and, last but not least, an overview of inherent risk. The important Hong Kong Standards of Auditing (HKSAs) for this area are HKSA 200 and HKSA 315.

Hong Kong Standards on Auditing (HKSAs)

HKSA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing"

HKSA 200.11 states that
"In conducting an audit of financial statements, the overall objectives of the auditor are:
(a) To obtain ***reasonable assurance*** *about whether the financial statements as a whole are* ***free from material misstatement***, ***whether due to fraud or error****, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;"*

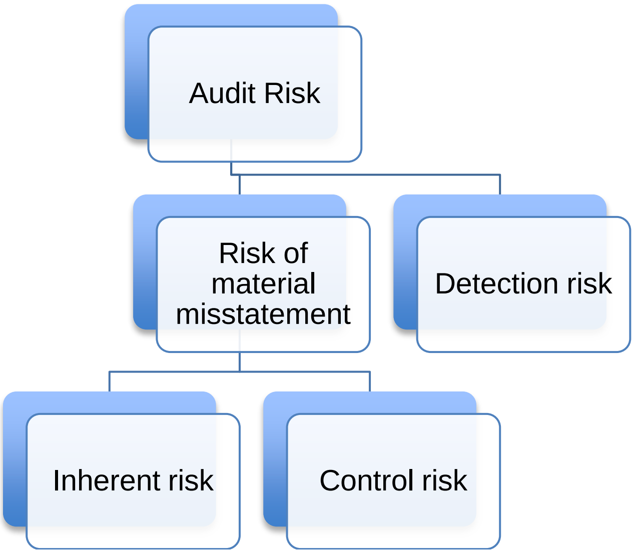
HKSA 315 (Revised) "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment"

HKSA 315.3 states that
"The objective of the auditor is ***to identify and assess the risks of material misstatement, whether due to fraud or error****, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement."*

Audit Risk

Audit risk is the risk that the auditor gives an inappropriate audit opinion. For example, the auditor fails to detect material misstatement(s) after completing the audit and expresses an unqualified opinion despite the fact that the financial statements are materially misstated.

Audit risk has two elements: risk of material misstatement and detection risk. Risk of material misstatement is the combination of inherent risk and control risk.



The Two Elements of Audit Risk

As illustrated above, audit risk can be split into risk of material misstatement and detection risk.

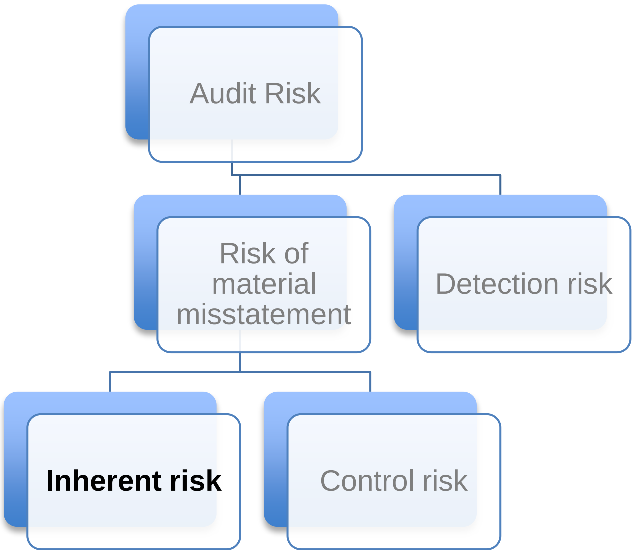
- **Risk of material misstatement**
  - Risk that the financial statements are materially misstated even before the start of any audit work.
  - Example: A business entity has assigned the cost of its inventories using the last-in-first-out (LIFO) method, which is not acceptable under Hong Kong Accounting Standard (HKAS) 2 "Inventories".

- **Detection risk**
  - Risk when audit procedures do not detect a misstatement or misstatements which can be material by itself or in total.
  - Example (cont'd): The client entity as described above has adopted an unacceptable accounting method to value its inventories, but the auditor is not aware of the misstatement.

The auditor should be aware of the interrelationship between risk of material misstatement and detection risk. In order to reduce audit risk to an acceptable level, the auditor needs to identify and assess the risk of material misstatement, and keep detection risk under control.

When the auditor estimates a risk of material misstatement to be higher than the acceptable level, the auditor generally plans to lower detection risk. A lower detection risk requires the support of more audit evidence. To collect more audit evidence, more substantive testing needs to be performed. Generally, the auditor can reduce detection risk by performing more substantive testing. The process usually begins in the first phase of the audit and carries on throughout the entire audit.

Risk of material misstatement relates mainly to the business activities and internal controls within the client entity. The auditor therefore does not have any influence over this risk. Nevertheless, to try to better understand this risk, it is necessary to comprehend its two components: inherent risk and control risk. Here, we focus on inherent risk.



Inherent Risk

Definition

The susceptibility of an assertion about a transaction, account balance or disclosure to a misstatement, individually or in total with other misstatements, that can be material, **assuming no related internal controls.**

This means that the auditor assesses the likelihood of material misstatement before considering the effectiveness and impact of the client entity's internal control.

Factors Affecting Inherent Risk

There are many factors affecting a client entity's inherent risk. Common factors include:

1. **Nature of the Client's Business**
    - An entity in the fast-changing high-technology industry faces a risk of inventory obsolescence. Rapid innovations can cause the entity's products to become obsolete very quickly and the inventory may not be appropriately valued. This risk is inherent in the business of the entity.

- Recognising this fact, the audit firm will probably decide that there is a high inherent risk, and hence assigns an experienced auditor to conduct more extensive tests and more carefully review inventory.

2. **Results of Previous Audits**
   - If material misstatements were discovered in the previous audit, it is possible that same kind of material misstatements may have occurred in the current year.
   - For example, when material misstatements, individually or in total, in pricing inventory had been discovered in the previous audit, the auditor tends to use a high inherent risk in the current year's audit and performs more extensive tests in order to assess whether the deficiency in the client's system has been followed up and amended.

3. **Initial vs. Repeat Engagement**
   - After auditing the same client for a number of years, the auditor gains substantial experience and relevant knowledge about the engagement. It makes sense for the auditor to feel more confident in auditing the same client instead of a new one.
   - Usually, the auditor is likely to set a high inherent risk in the first year of an audit and gradually lowers this risk level as they obtain more experience and knowledge about the client.

4. **Related Parties**
   - Transactions between parent and subsidiary entities, and transactions between management or the owner and the entity, are considered related-party transactions.
   - Since related-party transactions do not take place between two independent parties at arm's length or on an equal footing, there is a lack of transparency. Without enough confidence, the auditor probably sets a high inherent risk in the audit.

5. **Non-routine Transactions**
   - Non-routine or unusual transactions include, but are not limited to, losses due to fires, major property acquisitions, asset write-offs, and new product implementation.
   - When recording transactions that occur infrequently, the client may not have sufficient and adequate experience to record them correctly. The client is more likely to make mistake(s) due to a lack of relevant experience. It is logical for the auditor to estimate a high inherent risk in this situation.

6. **Judgment Required**
   - There are situations when the management of the client entity needs to exercise a great deal of judgment in estimating and recording transactions.
   - Examples: certain investments recorded at fair value, allowances for uncollectible trade receivables, write-off of obsolete inventory, product warranty payable, and reserves for bank loan loss.
   - The greater the exercise of judgment required, the greater the likelihood of misstatements. Thus, the auditor is more likely to assess a high inherent risk.

7. **Make-up of the Population**
   - From the auditor's perspective, the nature of items making up the total population often affects the likelihood of material misstatements. A higher likelihood of misstatement leads to more investigation and testing.

- As a result, the auditor sets a higher inherent risk for possibly questionable items such as trade receivables with many overdue accounts, inventories with a low turnover, transactions with related parties, amounts due from officers, and cash disbursements.

Conclusion

In preparing the audit programme, the auditor needs to understand and assess relevant risk and materiality issues. By adopting this risk analysis approach, the auditor then designs the audit programme to collect a sufficient amount of persuasive evidence for the operating cycle and components of the client entity. The audit risk model helps the auditor to grasp the interrelationship among risk elements affecting the client's operating cycle. Before considering the effectiveness of internal controls, assessing inherent risk is a significant element in understanding the client's environment and business.

References

HKSA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing", issued June 2009; revised July 2010, May 2013, Hong Kong Institute of Certified Public Accountants

HKSA 315 (Revised) "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", revised July 2012, December 2012, Hong Kong Institute of Certified Public Accountants