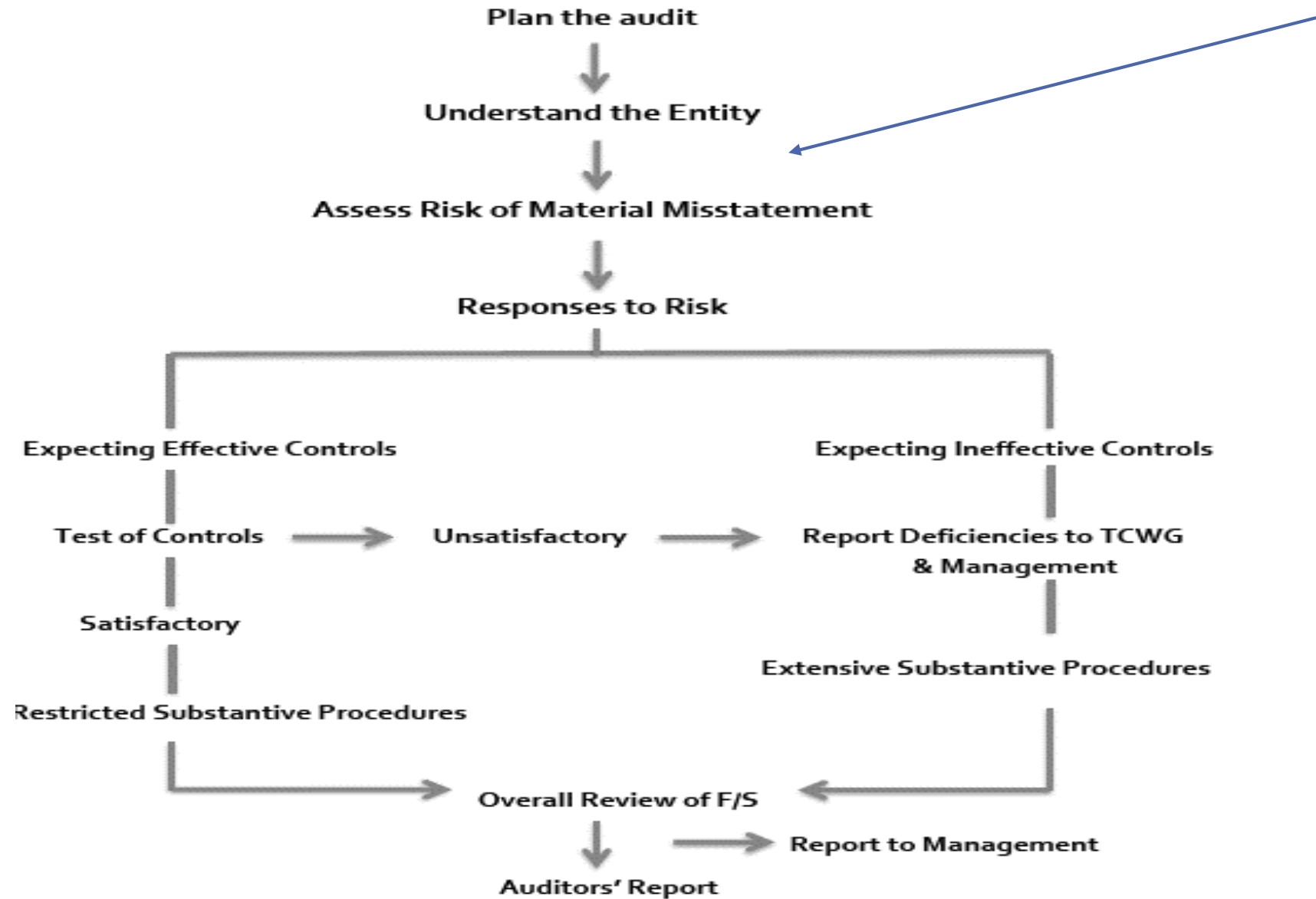


Section 3

Risk

Stages of an Audit



Audit Approaches

Substantive Approach

- In this approach, audit resources are targeted on testing large volumes of transactions and account balances without any particular focus on specified areas of the financial statements.

System Based Approach

- This approach requires auditors to assess the effectiveness of the internal controls of an entity, and then to direct substantive procedures.

Risk Based Approach

- In this approach, audit resources are directed towards those areas of the financial statements that may contain misstatements as a consequence of the risks faced by the business.

Understanding the Entity's Business

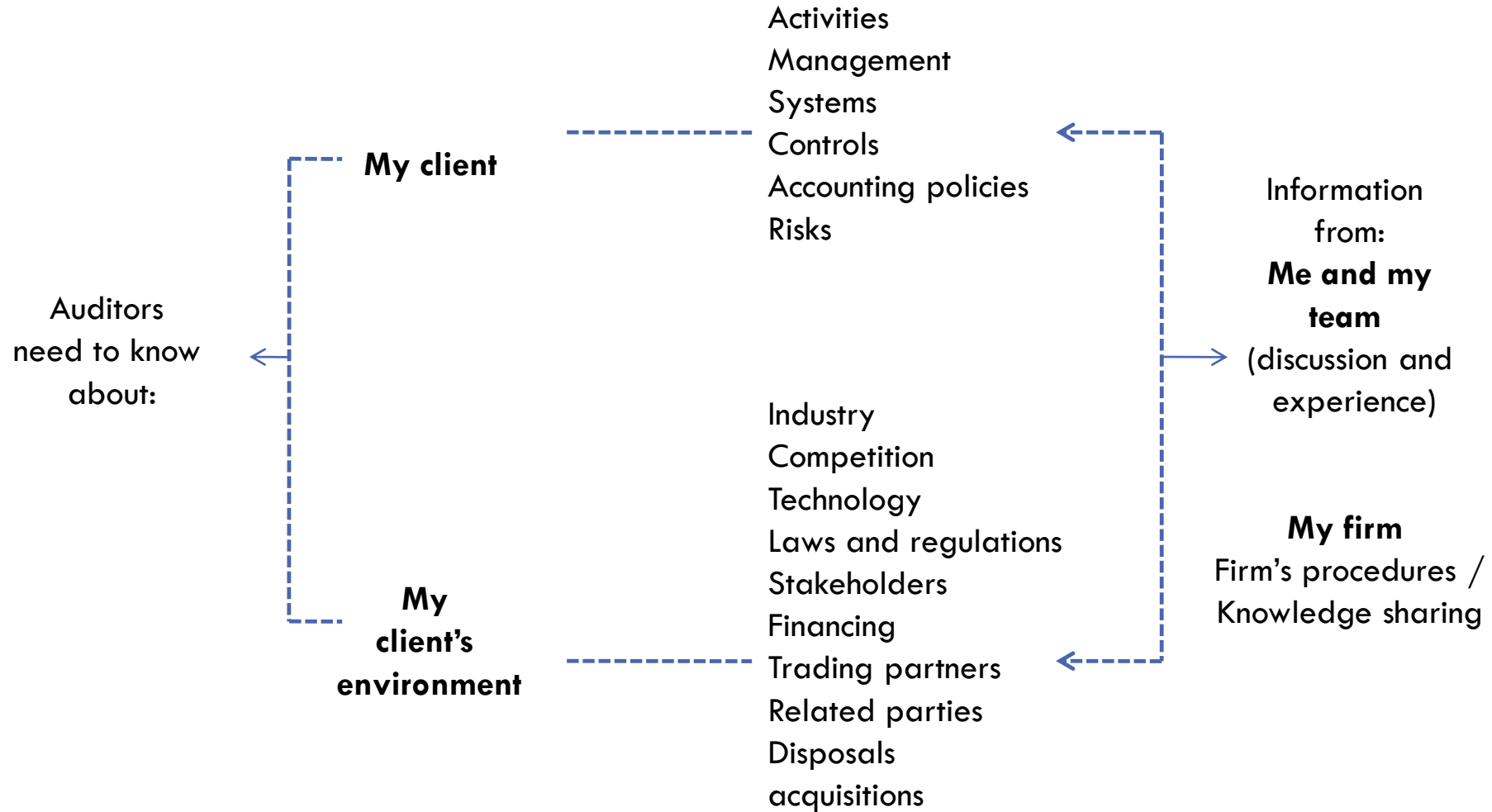
The auditor is required to **identify and assess the risks of misstatement** through understanding the entity and its environment, including its internal controls.

This will involve considering such factors as:

- Industry and regulatory factors
- Applicable financial reporting framework.
- The nature of the entity, its operations, ownership, management structures
- Types of current and planned investments
- The entity's selection and application of accounting policies and their consistency
- The entity's objectives and strategies
- Business risks that may result in risks of material misstatement.
- The measurement and review of the entity's financial performance.

K O B & Its Sources

KOB is the key to assessing risk.



Link between business risk, risk of material misstatement & audit risk

Audit risk is simply that auditor expresses an inappropriate opinion on financial statements whereas **business risks and risk of material misstatement** relate to the entity and

Business risk is the risk occurring that could affect an entity's ability to achieve its objectives.

Although audit risks and business risks are dissimilar in nature, it is often the case that identification of significant business risks lead to the audit risks as we can see in the following example:

Risk of material misstatement is a risk that financial statement may contain the material misstatement.

Example

Matter

The Board of Director of a company accepted the proposal of the Finance Director to sell off a low performing subsidiary of the Company after two year.

Business Risk

The full worth of the subsidiary may not be realized by the company through the sale transaction.

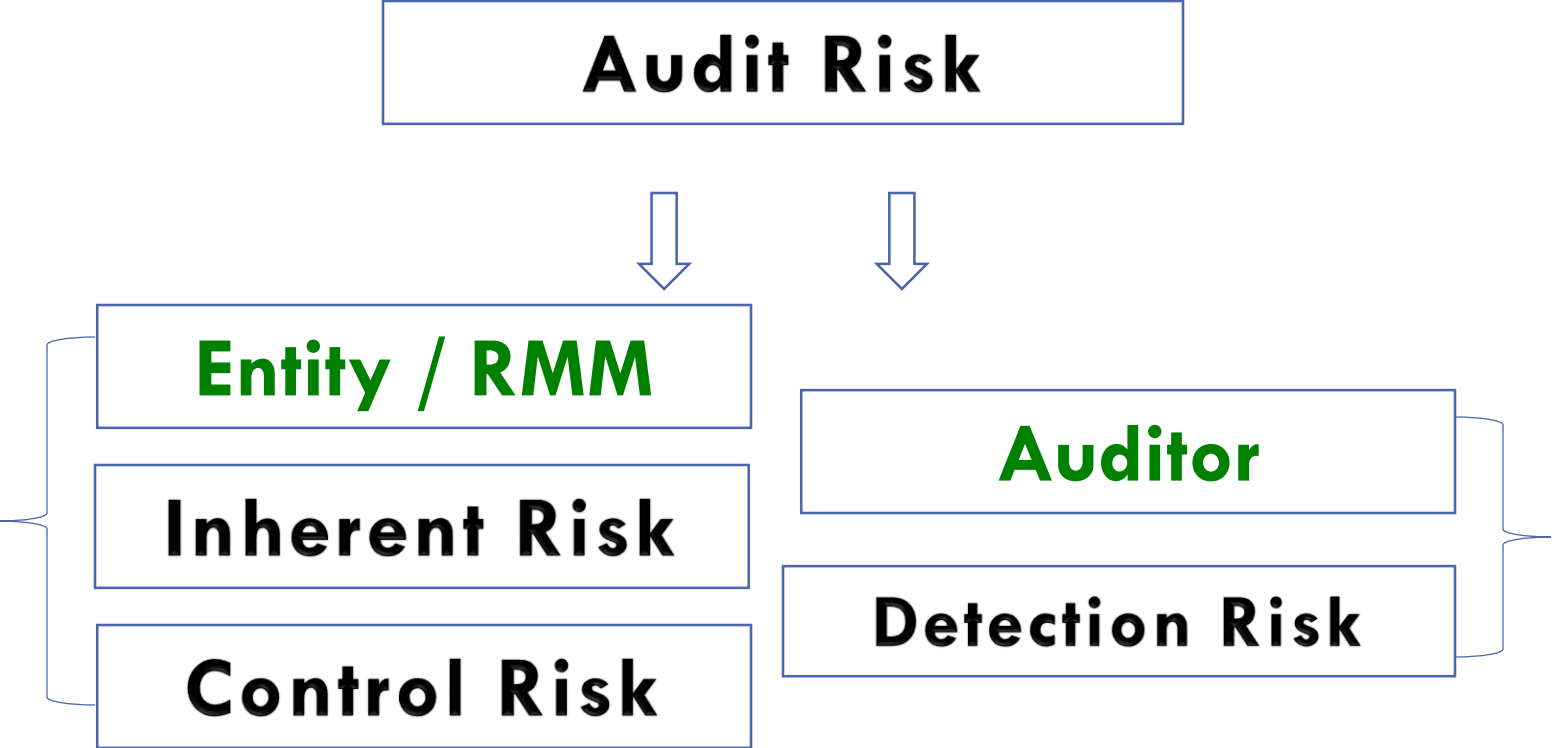
Risk of material misstatement

Financial results of the subsidiary might be manipulated to influence the market value of its shares prior to the sale transaction.

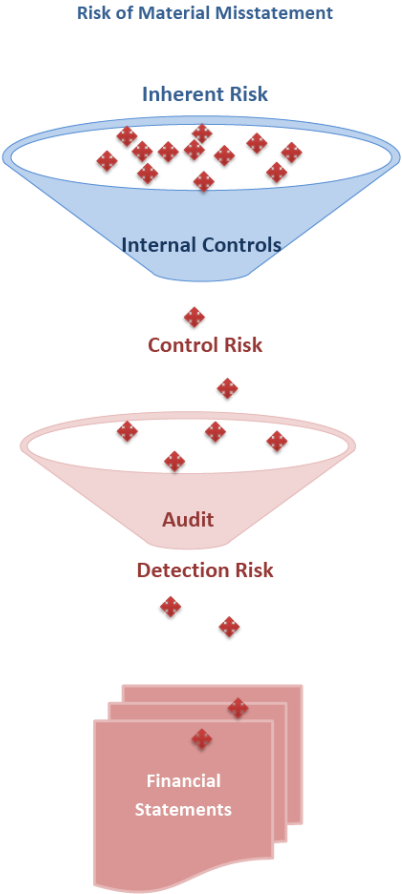
Audit Risk

Auditor fails to report the effect of manipulated Financial results of the subsidiary in his audit report.

Components of Risk

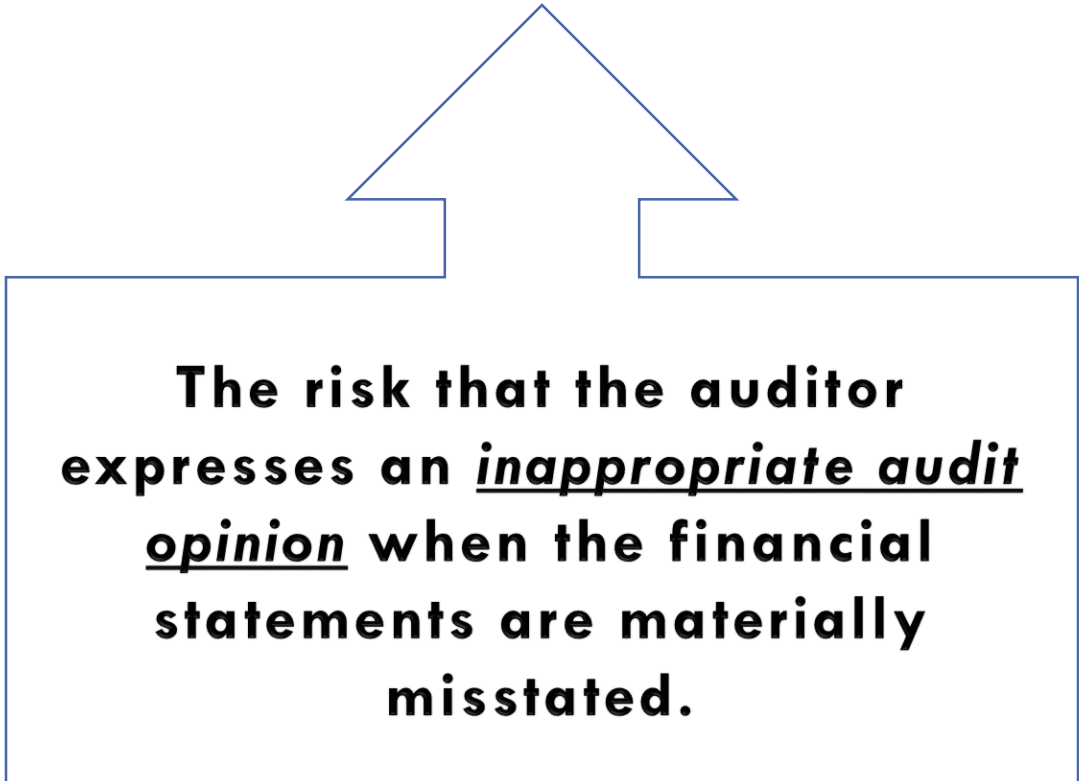


Audit Risk Explained



Components of Risk

Audit Risk



Components of Risk

**The susceptibility of an assertion
to a misstatement, before
consideration
of any related controls.**

Inherent Risk

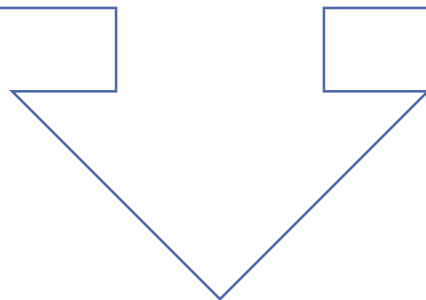
Components of Risk

The risk that a misstatement that could occur in an assertion will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control Risk

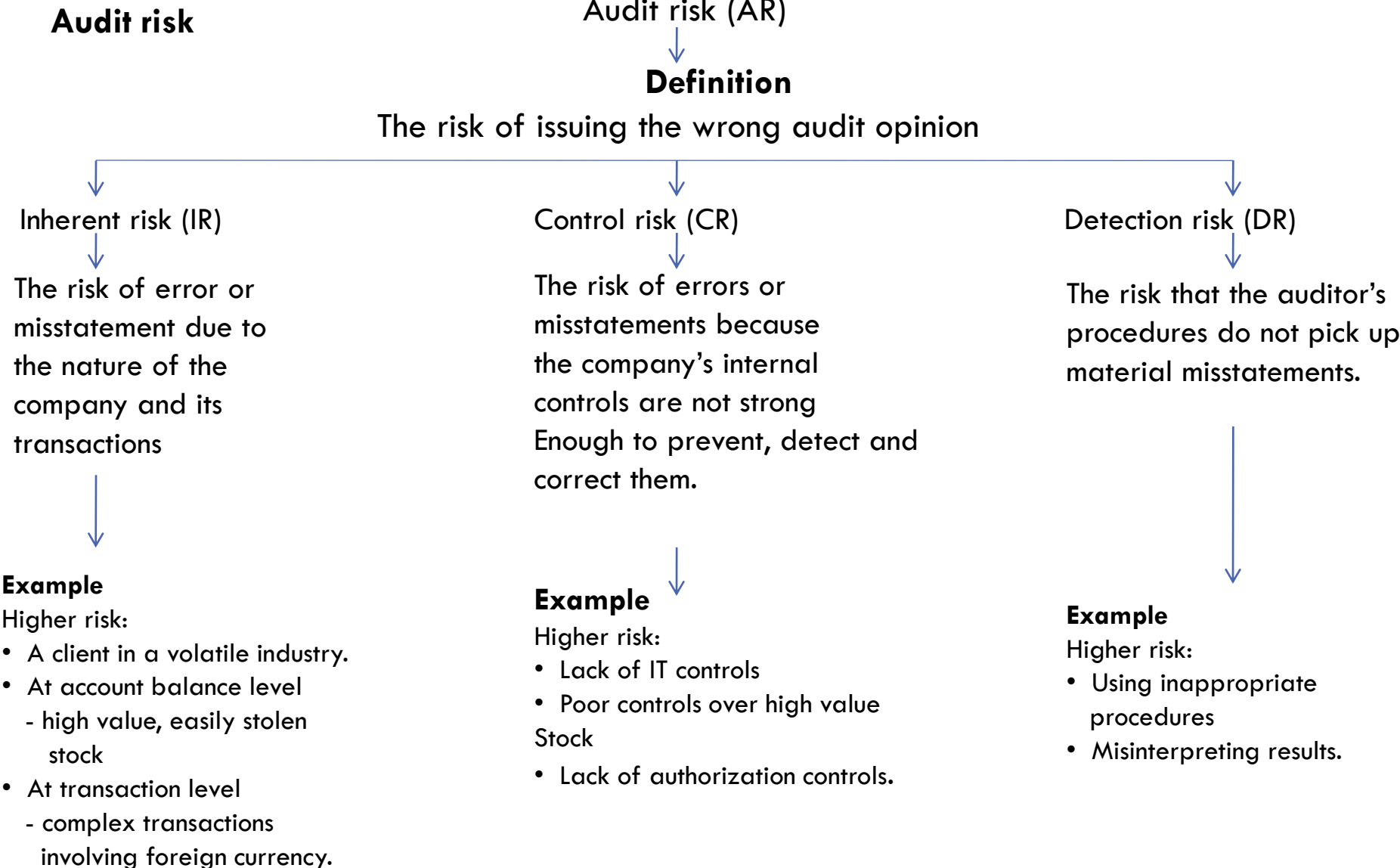
Components of Risk

The risk that the procedures performed by the auditor to reduce audit Risk will not detect a misstatement that exists

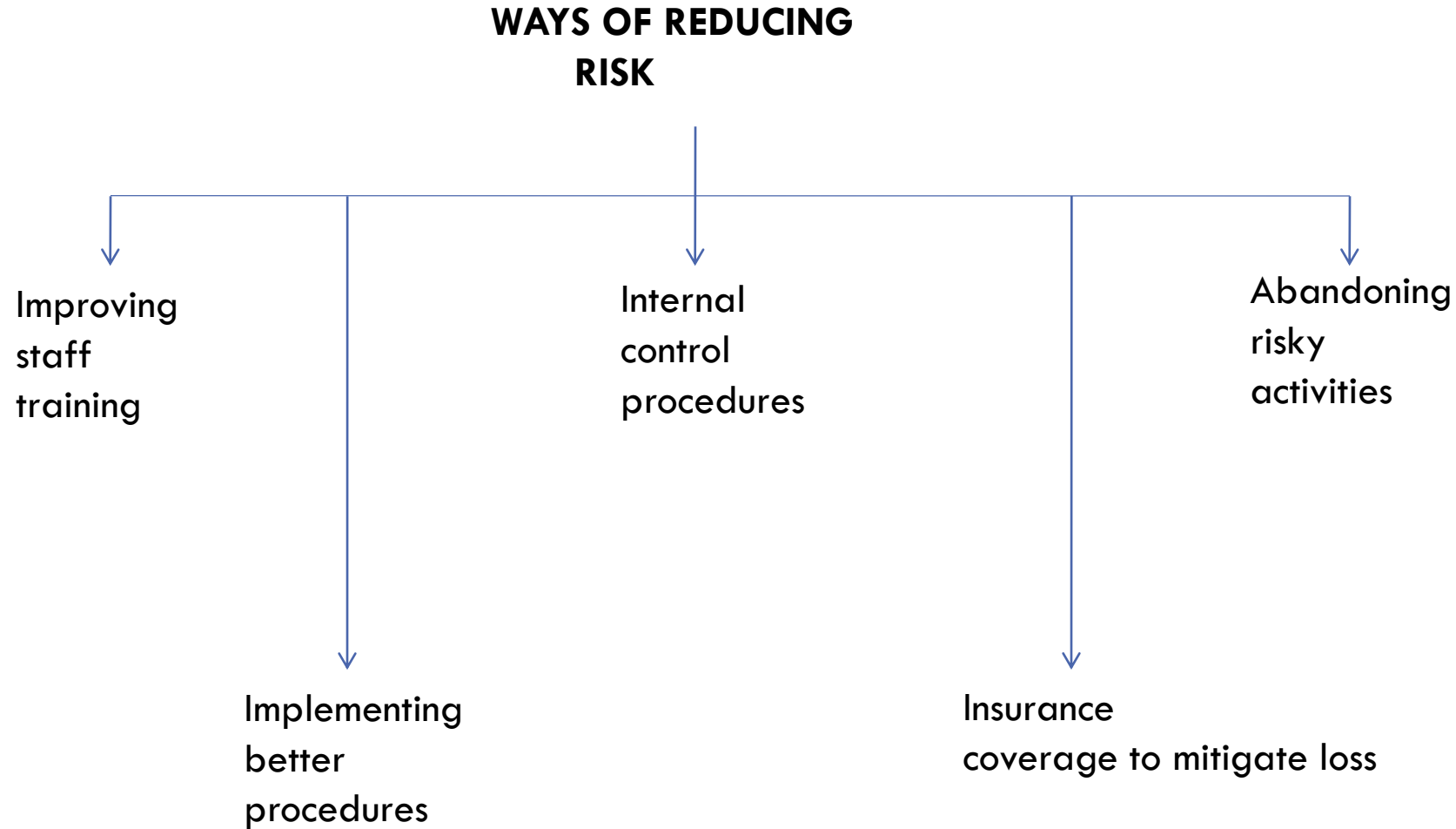


Detection Risk

Components of Audit Risk



Ways of reducing entity's risks



RMM at financial statements as well as assertion level

At Financial Statement Level:

Risks at financial statement level are those which are pervasive (vast) to the financial statements as a whole and which potentially affect many assertions.

At Assertion Level:

Risk at assertion level are those which relate to specific objectives of the financial statements.

Assertion

Dictionary meaning - A confident statement of the fact or belief.

ISAs definition – Representations (formal statements) by management, that are embodied (included) in the financial statements, as used by the auditor to consider the different type of potential misstatements that may occur.

ISAs definition simplified – Claims by management regarding the appropriateness of the various elements of financial statements and disclosures.

Quick Revision – Topics Covered

1. Audit approaches
2. Understanding the entity, its environment including its internal controls
3. KOB and its sources
4. Components of Audit Risk – IR, CR, and DR
5. Ways of reducing entity's risks
6. RMM at financial statements as well as assertion level
7. Practiced 1 TBQ 4 SBQs