Auditing And Assurance

Lecture -4

Topics covered:

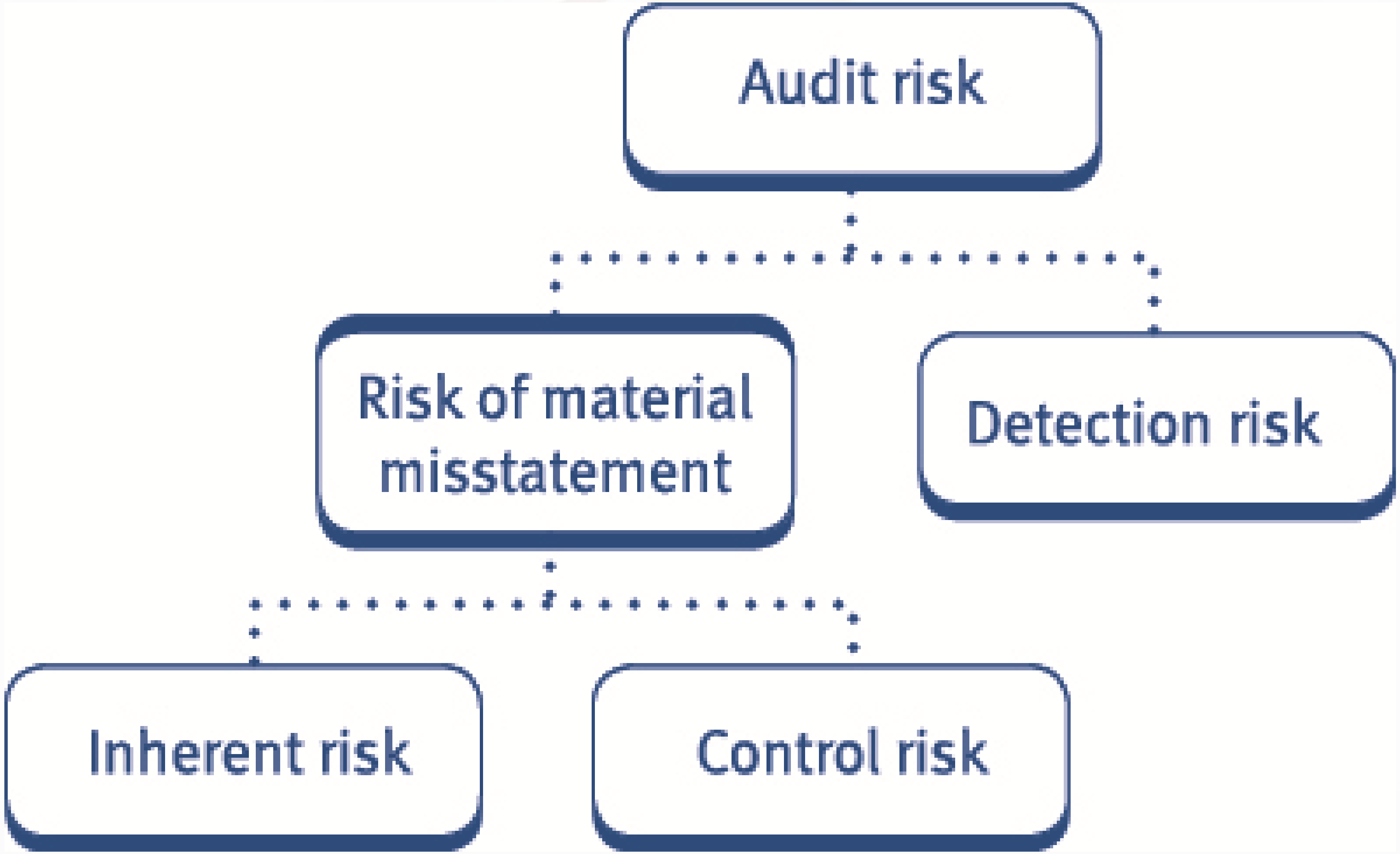
- Meaning of Audit Risk
- Types of audit risk
- Meaning of material misstatement
- Categories of misstatement
- Inherent risk
- Control risk
- Detection risk

Audit Risk

- **Audit risk** is the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated.
- This means that they give an unmodified audit opinion when the financial statements are materially misstated.

Types of Audit risk:

1. Risk of material Misstatement
2. Detection Risk


Audit risk
Risk of material misstatement
Detection risk
Inherent risk
Control risk

Risk of material misstatement

- **Risk of material misstatement** is the risk that the financial statements are materially misstated prior to the audit.
- This will be due to fraud or errors occurring during the year when transactions have been processed or when the financial statements have been prepared.

What is a misstatement?

- A **difference between** the amount, classification, presentation, or disclosure of a reported **financial statement** item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

Categories of misstatements:

(i) **Factual misstatements**: A misstatement about which there is no doubt.

(ii) **Judgmental misstatements**: A difference in an accounting estimate that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.

(iii) **Projected misstatements**: a projected misstatement is the auditor's best estimate of the total misstatement in a population through the projection of misstatements identified in a sample.

Inherent risk

The susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement that could be material, before consideration of any related controls.

- Complex accounting treatment is an example of an inherent risk. For example, where an accounting standard provides guidance on a specific accounting treatment this might not be understood by the client and material misstatement could result.
- Inherent risk may arise due to the nature of the industry, entity or the nature of the balance itself. For example, inventory is inherently risky if it quickly becomes obsolete as it may not be valued appropriately at the lower of cost and NRV as required by IAS 2 *Inventories*.

Control risk

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

Control risk may be high either because the design of the internal control system is insufficient in the circumstances of the business or because the controls have not been applied effectively during the period.

Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material.

- Detection risk comprises **sampling risk** and **non-sampling risk.**

Sampling risk is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached if the whole population was tested, i.e. the sample was not representative of the population from which it was chosen. [ISA 530 *Audit Sampling*, 5c]

Non-sampling risk is the risk that the auditor's conclusion is inappropriate for any other reason, e.g. the application of inappropriate procedures or the failure to recognize a misstatement.

References

- ACCA Study Material, F8 Kaplan Publishing
- Pic credit: www.istock.com